

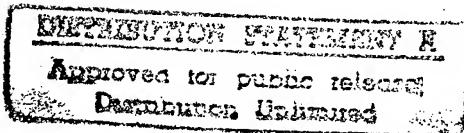
February 1996

MEXICO'S FINANCIAL CRISIS

Origins, Awareness, Assistance, and Initial Efforts to Recover

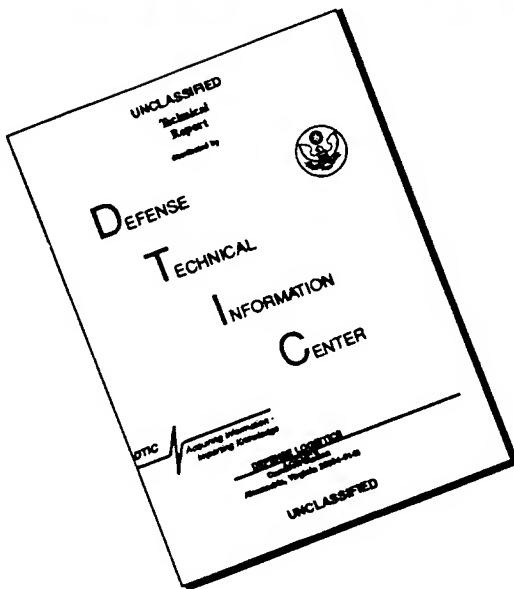


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GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-261008

February 23, 1996

The Honorable James A. Leach
Chairman, Committee on Banking
and Financial Services
House of Representatives

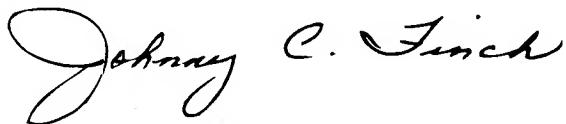
Dear Mr. Chairman:

This report responds to your request concerning Mexico's financial crisis. The report examines the origins of Mexico's financial crisis; assesses the extent to which the U.S. government and the International Monetary Fund (IMF) were aware of Mexico's financial problems throughout 1994 and provided advice to Mexico; describes the U.S. and international response to the crisis, including an assessment of the terms and conditions of the agreements implementing the U.S. portion of the assistance; provides an analysis of the statutory authority for the Secretary of the Treasury's use of the Exchange Stabilization Fund (ESF) to fund the assistance package; and examines the initial efforts of Mexico to recover from the crisis, including Mexico's access to international capital markets.

We are sending copies of this report to interested Members of Congress, appropriate committees, executive branch agencies, and Mexican financial officials. Copies will also be made available to others upon request.

If you have any questions concerning this report, please call JayEtta Hecker, Associate Director of International Relations and Trade Issues, at (202) 512-8984. Other major contributors to this report are listed in appendix IV.

Sincerely yours,



Johnny C. Finch
Assistant Comptroller General

Executive Summary

Purpose

Mexico's devaluation of the peso in December 1994 precipitated a crisis in Mexico's financial institutions and markets that continued into 1995. Investor confidence collapsed as investors sold Mexican equity and debt securities, and foreign currency reserves at the Bank of Mexico were insufficient to meet the demand of investors seeking to convert pesos to U.S. dollars. In response to this crisis, the United States organized a financial assistance package of up to \$48.8 billion in funds from the United States, Canada, the International Monetary Fund (IMF), and the Bank for International Settlements (BIS). The multilateral assistance package was intended to enable Mexico to avoid defaulting on its debt obligations, and thereby overcome its short-term liquidity crisis, and to prevent the crisis from spreading to other emerging markets.

In light of U.S. commitments to lend Mexico up to \$20 billion, the Chairman of the House Committee on Banking and Financial Services asked GAO to prepare a comprehensive report on Mexico's 1994-95 financial crisis. In response to this request, GAO (1) examined the origins of Mexico's financial crisis; (2) assessed the extent to which the U.S. government and IMF were aware of the severity of Mexico's financial problems throughout 1994 and provided financial advice to Mexico; (3) described the U.S. and IMF response to the crisis, and provided an analysis of the statutory authority of the Secretary of the Treasury to use the Exchange Stabilization Fund (ESF) to finance the package and an assessment of the terms and conditions of the various agreements implementing the U.S. portion of the assistance;¹ and (4) examined the initial efforts of Mexico to recover from the crisis, which included a discussion of Mexico's access to international capital markets. GAO did not address the issue of whether Mexico would be able to repay the United States for the assistance.

To achieve its objectives, GAO reviewed documents and spoke with officials about (1) the risks encountered in international finance; (2) the history of U.S. and IMF financial assistance for Mexico; (3) the recent economic and financial reforms in Mexico; (4) the economic factors leading to Mexico's financial crisis, including monetary policy, fiscal policy, exchange rate policy, foreign exchange reserves, debt financing, and current account balance;² (5) the political factors contributing to the

¹In the past ESF has been used to buy and sell foreign currencies, extend short-term swaps to foreign countries, and guarantee obligations of foreign governments. Its use must be consistent with U.S. obligations in IMF regarding orderly exchange arrangements and a stable system of exchange rates.

²A country's current account measures its transactions with other countries in goods, services, investment income, and other transfers.

loss of investor confidence in Mexico; (6) the financial health of the Mexican banking system; (7) the U.S. and IMF assistance package, including statutory authority, objectives, funding, and terms and conditions; (8) congressional and other criticisms of the package; (9) implementation of the package; (10) Mexico's post-crisis economic plan; and (11) the initial effects of the package on the Mexican economy and Mexico's ability to borrow on international capital markets.

GAO interviewed officials from (1) the U.S. Department of the Treasury, Mexico's Secretaria de Hacienda y Credito Publico (Ministry of Finance), the U.S. Federal Reserve System, and the Bank of Mexico; (2) the U.S. Department of State and Mexico's Secretaria de Relaciones Exteriores; (3) IMF; (4) the Mexican Banking and Securities Commission as well as officials of two government-sponsored development banks in Mexico; (5) 10 investment and commercial banks based in the United States, Mexico, and Europe; (6) 2 U.S. global bond and equity funds with sizable investments in Mexico; and (7) international and Latin American economic experts at universities and private research organizations. GAO reviewed U.S. and Mexican government, international organization, and private firm documents, including correspondence, memorandums, testimony, cable traffic, reports, books, regulations, and laws. GAO was provided copies of and access to large numbers of U.S. government documents—about 15,000 pages of information—from the U.S. Department of the Treasury, the Federal Reserve System, and the Department of State.

Background

Historically, the U.S. and Mexican economies have been closely integrated. In 1994, the United States supplied 69 percent of Mexico's imports and absorbed about 85 percent of its exports. U.S. investors have provided a substantial share of foreign investment in Mexico and have established numerous manufacturing facilities in Mexico. Also, the United States has served as a large market for Mexican labor. U.S. economic dependence on Mexico has been less substantial. Nonetheless, Mexico has been the third largest trading partner of the United States, accounting for 10 percent of U.S. exports and about 8 percent of U.S. imports in 1994.

Mexico has experienced several financial crises since 1976 and on a number of occasions has received U.S. financial assistance to help it deal with such crises as well as other difficulties. Mexico's last major financial crisis before 1994 was in 1982, when Mexico was unable to meet its obligations to service \$80 billion in mainly dollar-denominated debt obligations to U.S. and foreign banks. At that time, the United States took

the lead in developing an assistance package. The package included short-term currency swaps³ from the Federal Reserve and ESF, a commitment from Mexico to an IMF economic austerity program, \$4 billion in IMF loans, and a moratorium on Mexico's principal payments to commercial banks in the United States and other countries. It also included \$5 billion in additional commercial bank loans, liquidity support from central banks in Europe and Japan, and prepayment by the United States to Mexico for \$1 billion in Mexican oil.

By the late 1980s, Mexico had largely resolved its debt crisis and was able to resume economic growth. Mexico continued to rely to a great extent on foreign investment to finance such growth. To attract foreign capital, the Mexican government undertook major structural reforms in the early 1990s designed to make its economy more open to foreign investment, more efficient, and more competitive. These reforms included privatizing many state-owned enterprises, removing trade barriers, removing restrictions on foreign investment, and reducing inflation and government spending. In 1994, Mexico entered into the North American Free Trade Agreement (NAFTA) with the United States and Canada. NAFTA further opened Mexico to foreign investment and bolstered foreign investor confidence in Mexico because investors perceived that with NAFTA, Mexico's long-term prospects for stable economic development were likely to improve.

Mexico also adopted an exchange rate system intended to help stabilize the economy. In 1988, the nominal exchange rate⁴ of the peso was fixed temporarily in relation to the U.S. dollar. However, because the inflation rate in Mexico was greater than that in the United States, a peso nominal depreciation⁵ against the dollar was needed to keep the real exchange rate⁶

³Short-term currency swaps are repurchase-type agreements through which currencies are exchanged. Mexico purchases U.S. dollars in exchange for Mexican pesos and simultaneously agrees to sell dollars against pesos 3 months hence. The United States earns interest on its Mexican pesos at a specified rate.

⁴The nominal exchange rate of a currency is the actual price at which one currency can be exchanged for another currency at any point in time.

⁵Depreciation is a decline in the value of one currency relative to that of another in foreign exchange markets. Devaluation is the downward adjustment in the official exchange rate of a nation's currency.

⁶A change in the real exchange rate of a currency takes into account the impact of both a change in the nominal exchange rate of that currency as well as the impact of domestic and foreign inflation. For example, if over the course of a year the inflation rate in Mexico were 20 percent higher than the inflation rate in the United States, and the peso price of dollars increased by 20 percent, the real exchange rate of the peso would not change. However, if the inflation rate in Mexico were 20 percent higher than that in the United States and the peso were to depreciate by only 5 percent, the real exchange value of the peso would increase, or appreciate, by about 15 percent.

of the peso from increasing. Since the nominal exchange rate of the peso was fixed, the real exchange rate of the peso appreciated during this period. In 1989, this fixed exchange rate system was replaced by a "crawling peg" system, under which the peso/dollar exchange rate was adjusted daily to allow a slow rate of nominal depreciation of the peso to occur over time. In 1991, the crawling peg was replaced with a band within which the peso was allowed to fluctuate. The ceiling of the band was adjusted daily to permit some appreciation of the dollar (depreciation of the peso) to occur. The Mexican government used the exchange rate system as an anchor for economic policy, i.e., as a means to reduce inflation, encourage a disciplined fiscal policy, and thus provide a more predictable climate for foreign investors.

Before 1994, Mexico's strategy of adopting sound monetary and fiscal policies appeared to be having its intended effects. Inflation had been steadily reduced, government spending was down, and foreign capital investment was large. Moreover, unlike the years before 1982, most foreign capital was flowing to Mexico's private sector rather than to the Mexican government to finance budget deficits. Although Mexico was experiencing a very large current account deficit,⁷ both in absolute terms and in relation to the size of its economy, this did not appear to present an immediate problem for the following reasons: Mexico's foreign currency reserves were plentiful, its exports were growing rapidly, and there did not seem to be significant risk that Mexico soon would have trouble attracting and retaining foreign investment. The situation changed in late 1994.

Results in Brief

According to GAO's analysis, Mexico's financial crisis originated in the growing inconsistency in 1994 between Mexico's monetary and fiscal policies and its exchange rate system. Due in part to an upcoming presidential election, Mexican authorities were reluctant to take actions in the spring and summer of 1994, such as raising interest rates or devaluing the peso, that could have reduced this inconsistency. This fundamental policy inconsistency was exacerbated by the Mexican government's response to several economic and political events that created investor concerns about the likelihood of a currency devaluation. In response to investor concerns, the government issued large amounts of short-term, dollar-indexed notes called "tesobonos." By the beginning of December 1994, Mexico had become particularly vulnerable to a financial

⁷A country can respond to a current account deficit in a number of ways. These include (1) attracting more foreign capital; (2) allowing its currency to depreciate, thus making imports more expensive and exports cheaper; (3) tightening monetary and/or fiscal policy to reduce the demand for all goods, including imports; and (4) using foreign exchange reserves to cover the deficit.

market crisis because its foreign exchange reserves had fallen to \$12.5 billion while it had tesobono obligations of \$30 billion maturing in 1995.

Throughout 1994, the U.S. government monitored economic and political developments that affected the value of Mexico's peso. In early 1994, U.S. officials had some concerns over the sustainability of Mexico's exchange rate policies in the short run. They were aware that Mexico was experiencing a large current account deficit financed mostly by short-term portfolio capital that was vulnerable to a sudden reversal of investor confidence in Mexico. However, a number of other considerations pointed to a more optimistic view of Mexico's near-term economic prospects. Concerns grew during the year as pressure on the peso increased, as Mexico's foreign exchange reserves were drawn down, and as its current account deficit widened. During March and August, the Federal Reserve and Treasury made two large swap facilities potentially available to Mexico that would allow Mexico to improve its ability to cope with short-term pressure on the peso in international foreign exchange markets.⁸ Mexico did not use these facilities during this period. During October and November, high-level U.S. officials cautioned Mexican officials that the peso seemed overvalued and indicated that it was risky to continue the existing exchange rate policy. U.S. officials, however, were undecided about the extent to which the peso was overvalued and if and when financial markets might force Mexico to take action. Moreover, Federal Reserve and Treasury officials did not foresee the magnitude of the crisis that eventually unfolded. IMF was less aware of the seriousness of the situation that was developing in Mexico during 1994 than was the U.S. government and, for most of 1994, did not see a compelling case for a change in Mexico's exchange rate policy.

The objectives of the U.S. and IMF assistance packages, following the December devaluation and the subsequent loss of confidence in the peso, were (1) to help Mexico overcome its short-term liquidity crisis and (2) to limit the adverse effects of Mexico's crisis spreading to the economies of other emerging market nations and beyond. Some observers opposed any U.S. financial assistance to Mexico. They argued that tesobono investors should not have been shielded from financial losses, and that neither the danger posed by the spread of Mexico's crisis to other nations nor the risk to U.S. trade, employment, and immigration were sufficient to justify such assistance.

⁸The August facilities were provided on a contingency basis in cooperation with other countries.

The U.S. and international response to Mexico's financial crisis was one of the largest multilateral economic assistance packages extended to any one country. The United States pledged up to \$20 billion in loans and securities guarantees from ESF. As part of the amount, the Federal Reserve agreed to provide up to \$6 billion in short-term swaps from its preexisting swap line. The Treasury Department agreed to provide backing for the Federal Reserve swaps as part of the ESF program by assuring repayment of any short-term drawings that were counted against the \$20 billion limit. U.S. assistance was offered through three mechanisms: (1) short-term currency swaps for up to 90 days, with renewals allowed for a maximum term of 1 year for Treasury swaps and renewals up to three times for Federal Reserve swaps; (2) medium-term currency swaps for up to 5 years; and (3) securities guarantees under which ESF funds could be used to back up securities issued by Mexico's government for up to 10 years. IMF pledged up to \$17.8 billion in financial assistance in the form of a standby arrangement for Mexico to be disbursed over a period of 18 months.⁹ IMF assistance was designed to bolster gross international reserves and was conditional upon several things, including Mexico's reducing its current account deficit and its inflation rate, and strengthening its fiscal policy.

Mexico has been effectively charged the same interest rate that other countries pay for short-term currency swaps, a rate tied to the most recent issue of U.S. Treasury bills, which was 5.25 percent as of the end of October 1995. For its medium-term swaps, Mexico was charged interest rates intended to compensate the United States for the risks of longer-term lending to Mexico—7.55 percent in March, 10.16 percent in April, and 9.2 percent in July 1995. Similarly, Mexico has been charged standard rates and fees for its IMF assistance package, drawings under which have a maturity of up to 5 years. Interest rates for IMF drawings have been about 5 percent per year. In addition, Mexico was charged an annual 0.25 percent commitment fee for IMF funds remaining available and a 0.50 percent usage fee on each of its IMF drawings.

As part of the assistance package, the United States and Mexico entered into an oil agreement to ensure that in the event of a default by Mexico, the United States would be repaid both principal and interest from oil export revenues that flow through an account at the Federal Reserve Bank of New York. Mexico has funds on deposit in the Federal Reserve Bank of New York generated by the export sales of Mexican oil. Funds flowing through this account would be used to pay down Mexico's obligations in

⁹A standby arrangement is a commitment by IMF to provide funds that is conditional on the country's performance—particularly with respect to targets for economic policies (performance criteria) specified in a letter of intent.

the case of a default. More than \$6 billion has flowed through this special account from its activation on March 9, 1995, to November 30, 1995. However, the amount of funds flowing through the account during any single day would not be sufficient to cover a major default by Mexico.

Legal opinions from Treasury's General Counsel and the Department of Justice stated that the Secretary had the requisite authority to use ESF to provide assistance to Mexico through the three financing mechanisms previously described. GAO has no basis to disagree. Under the Gold Reserve Act, as amended, 31 U.S.C. § 5302, the Treasury Secretary has the authority to commit ESF funds if the commitment is consistent with IMF obligations of the U.S. government on orderly exchange arrangements and a stable system of exchange rates. The act provides the Secretary, with the approval of the President, the broad discretion to decide when the use of ESF is consistent with IMF obligations and states specifically that "the fund is under the exclusive control of the Secretary. . . ." 31 U.S.C. § 5302(2). In accordance with the discretion afforded him under the act, the Secretary concluded that the assistance package was consistent with the U.S. obligations to IMF because the Mexican financial crisis had a destabilizing effect on the peso's exchange rate and negative repercussions for the overall exchange rate system.

Mexico's economic reforms and the financial assistance package initially enabled Mexico to satisfy its external debt obligations and to begin to restructure its short-term debt into longer-term obligations. Furthermore, as a condition of the assistance, Mexico was required to adopt a strict economic plan to resolve its economic problems. While the short-term result has been a severe recession and economic hardship in Mexico, the plan is intended to lead in the longer run to sustained economic growth and an economy that will be attractive to foreign investors. The assistance package and the implementation of Mexico's economic plan have enabled Mexico to begin to return to international capital markets. Mexican development banks were able to borrow again in international capital markets by the spring of 1995. In addition, the government of Mexico and its agencies were able to return in the period July through November to international capital markets to borrow \$4 billion. Although the government of Mexico has taken steps to improve the Mexican banking system, the banking sector has remained burdened by a nonperforming loan level estimated by the World Bank at about 27 percent of total loans as of September 30, 1995.

Despite the progress to date, Mexico still faces many difficult challenges before its financial crisis can be resolved. Interest rates continue to be high, the peso continues to be volatile, the banking sector remains strained, and economic growth is weaker than predicted. Thus, it remains to be seen whether Mexico will be able to maintain economic policies that will allow the economy to recover from the crisis.

Principal Findings

Origins of the Financial Crisis

The evidence GAO reviewed showed that the origins of Mexico's financial crisis can be found in the interplay of a number of complex financial, economic, and political factors during 1994. In combination, these factors made Mexico's monetary and fiscal policies inconsistent with its exchange rate policy. At the beginning of the year, Mexico was experiencing a boom in foreign investment. The boom was related in part to investors' perceptions that Mexico's economy was fundamentally strong. The investment surge was also bolstered by approval of NAFTA. However, a substantial part of the financial inflow was in the form of equity and debt portfolio investments¹⁰ that could be withdrawn quickly.

The first significant drop in investor confidence in Mexico in 1994 and the related drop in Mexican foreign currency reserves occurred following the assassination of Mexican presidential candidate Luis Donaldo Colosio on March 23. On March 24, U.S. authorities agreed to make available a temporary short-term credit facility of \$6 billion. Mexico's foreign currency reserves fell \$7.1 billion, from \$24.4 billion at the end of March to \$17.3 billion at the end of April. Mexican authorities attributed the decline in investor confidence primarily to the shock of the assassination and took several actions to stem the outflow of foreign exchange reserves. The peso was allowed to depreciate less than 1 percent against the dollar to the limit imposed by the exchange rate band. This followed a 7-percent depreciation that had taken place in the month preceding the assassination. In April 1994, in connection with the establishment of the North American Financial Group, a consultative body consisting of finance ministries and central banks of the United States, Canada, and Mexico, these three partners established a trilateral agreement to make available a

¹⁰Portfolio investments are assets held in the form of marketable equity and debt securities. Portfolio investment—in contrast to direct investment—tends to be more liquid in nature and more likely to be short term. This is not to suggest, however, that selling pressures on a currency are more likely to arise or be more severe in the presence of substantial foreign portfolio investment. Historically, there have been market-forced devaluations when portfolio investment has been almost nonexistent.

short-term credit facility of \$6 billion from the United States and one billion Canadian dollars. Also, the Bank of Mexico increased domestic interest rates from 9 percent to 18 percent on short-term, peso-denominated Mexican government notes called "cetes" in an attempt to stem the outflow of capital.

However, in spite of higher interest rates, investor demand for cetes continued to lag. Investors were demanding higher interest rates on newly issued cetes because of their perception that the peso would eventually be subject to a relatively large devaluation. Options available to the Mexican government at this time included (1) offering even higher interest rates on cetes; (2) reducing government expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso; or (3) devaluing the peso. From the perspective of Mexican authorities, the first two choices were unattractive in a presidential election year because they could have led to a significant downturn in economic activity and could have further weakened Mexico's banking system. The third choice, devaluation, was also unattractive, since Mexico's success in attracting substantial foreign investment depended on its commitment to maintain a stable exchange rate. In addition, a stable exchange rate had been an essential ingredient of long-standing policy agreements between government, labor, and business, and these agreements were perceived as ensuring economic and social stability. Also, the stable exchange rate was a key to continued reductions in the inflation rate.

Rather than adopt any of these options, the government chose, in the spring of 1994, to increase its issuance of tesobonos. Because tesobonos were dollar-indexed, holders could avoid losses that would otherwise result if Mexico subsequently chose to devalue its currency. The Mexican government promised to repay investors an amount, in pesos, sufficient to protect the dollar value of their investment. Tesobono financing effectively transferred foreign exchange risk from investors to the Mexican government.¹¹ Tesobonos proved attractive to domestic and foreign investors. However, as sales of tesobonos rose, Mexico became vulnerable to a financial market crisis because many tesobono purchasers were portfolio investors who were very sensitive to changes in interest rates and risks. Furthermore, tesobonos had short maturities, which meant that their holders might not roll them over if investors perceived (1) an increased risk of a Mexican government default or (2) higher returns elsewhere. Nevertheless, Mexican authorities viewed tesobono financing

¹¹Foreign exchange risk is the risk of unexpected adverse movements in exchange rates, causing a loss of value of assets or income denominated in the foreign currency.

as the best way to stabilize foreign exchange reserves over the short term and to avoid the immediate costs implicit in the other alternatives. In fact, Mexico's foreign exchange reserves did stabilize at a level of about \$17 billion from the end of April through August, when the presidential elections came to a conclusion. Mexican authorities said they expected that investor confidence would be restored following the August presidential election and that investment flows would return in sufficient amounts to preclude any need for continued, large-scale tesobono financing.

Following the election, however, foreign investment flows did not recover to the extent expected by Mexican authorities in part because peso interest rates were allowed to decline in August and were maintained at that level until December. During the fall of 1994, it became increasingly clear to some Mexican government officials that Mexico's mix of monetary, fiscal, and exchange rate policies needed to be adjusted. The current account deficit had worsened during the year, partly as a result of the strengthening of the economy related to a moderate loosening of fiscal policy, including a step up in development lending. Imports had also surged as the peso became increasingly overvalued. Mexico had become heavily exposed to a run on its foreign exchange reserves as a result of substantial tesobono financing. Outstanding tesobono obligations increased from \$3.1 billion at the end of March to \$29.2 billion in December. Also, between January 1994 and November 1994, U.S. 3-month Treasury bill yields had risen from 3.04 percent to 5.45 percent, substantially increasing the attractiveness of U.S. government securities.

In the middle of November 1994, Mexican authorities had to draw down foreign currency reserves in order to meet the demand for dollars. On November 15, in response to U.S. economic conditions, the U.S. Federal Reserve raised the federal funds rate by three-quarters of a percentage point, raising the general level of U.S. interest rates and further increasing the attractiveness of U.S. bonds to investors. Then in late November and early December, renewed fighting in the Mexican state of Chiapas and an unfolding scandal surrounding the September 1994 assassination of Institutional Revolutionary Party Secretary General Francisco Ruiz Massieu renewed apprehension among investors regarding Mexico's political stability. These concerns were compounded on December 9, when the new Mexican administration revealed that it expected an even higher current account deficit in 1995 but planned no change in its exchange rate policy. This decision led to a further loss in confidence by investors, increased redemptions of Mexican securities, and a significant

drop in foreign exchange reserves, to \$10 billion. Meanwhile, Mexico's outstanding tesobono obligations reached \$30 billion, with all coming due in 1995. However, Mexican government officials continued to assure investors that the peso would not be devalued.

On December 20, Mexican authorities sought to relieve pressure on the exchange rate by announcing a widening of the peso/dollar exchange rate band. The widening of the band effectively devalued the peso by about 15 percent. However, the government did not announce any new fiscal or monetary measures to accompany the devaluation—such as raising interest rates. This inaction was accompanied by more than \$4 billion in losses in foreign reserves on December 21, and on December 22, Mexico was forced to freely float its currency. The discrepancy between the stated exchange rate policy of the Mexican government throughout most of 1994 and its devaluation of the peso on December 20, along with a failure to announce appropriate accompanying economic policy measures, contributed to a significant loss of investor confidence in the newly elected government and growing fear that default was imminent. Consequently, downward pressure on the peso continued. By early January 1995, investors realized that tesobono redemptions could soon exhaust Mexico's reserves and, in the absence of external assistance, that Mexico might default on its dollar-indexed and dollar-denominated debt.

U.S. and IMF Advice to Mexico

As 1994 began, U.S. officials were somewhat concerned that Mexico was vulnerable to speculative attacks on the peso and that Mexico's large current account deficit and its exchange rate policy might not be sustainable. However, these concerns largely were outweighed by other considerations. For example, U.S. officials generally thought that Mexico's economy was characterized by sound economic fundamentals and that, with the major economic reforms of the past decade, Mexico had laid an adequate foundation for economic growth in the long term. Further, Mexico was attracting large capital inflows and had substantial foreign exchange reserves. Concerns about the viability of Mexico's exchange rate system increased following the assassination of Mexico's presidential candidate Luis Donaldo Colosio in the latter part of March and the subsequent drawdown of about \$10 billion in Mexican foreign exchange reserves by the end of April. Just after the assassination, Treasury and Federal Reserve officials temporarily enlarged longstanding currency swap facilities with Mexico from \$1 billion to \$6 billion. These enlarged facilities were made permanent with the establishment of the North American Financial Group in April. The initiative to enlarge the swap

facilities permanently preceded the Colosio assassination. Mexican foreign exchange reserves stabilized at about \$17 billion by the end of April.

At the end of June 1994, a new run on the peso was under way. Between June 21 and July 22, foreign exchange reserves were drawn down by nearly \$3 billion, to about \$14 billion. In early July, Mexico asked the Federal Reserve and Treasury to explore with the central banks of certain European countries the establishment of a contingency, short-term swap facility. That facility could be used in conjunction with the U.S.-Mexican swap facility to help Mexico cope with possible exchange rate volatility in the period leading up to the August election. By July, staff in the Federal Reserve had concluded that Mexico's exchange rate probably was overvalued and that some sort of adjustment eventually would be needed. However, U.S. officials thought that Mexican officials might be correct in thinking that foreign capital inflows could resume following the August elections. In August, the United States and BIS established the requested swap facility, but not until U.S. officials had secured an oral understanding with Mexico that it would adjust its exchange rate system if pressure on the peso continued after the election. The temporary facility incorporated the U.S.-Mexican \$6-billion swap arrangement established in April. At the end of July, pressure on the peso abated, and Mexican foreign exchange reserves increased to more than \$16 billion. Significant new pressure on the peso did not develop immediately following the August election, but at the same time, capital inflows did not return to their former levels.

According to the documents GAO reviewed, between August and December 20, 1994, U.S. government analyses generally concluded that the peso was overvalued. However, analysts were not sure to what extent the peso was overvalued and whether and when financial markets might force Mexico to devalue the peso. Estimates of the overvaluation ranged between 5 and 20 percent. As the year progressed, U.S. officials thought it increasingly likely that Mexico would have to devalue in the near future. However, as late as mid-December, U.S. government analysts and senior officials believed that Mexico might make it into early 1995 without having to devalue.

In spite of these uncertainties, during October and November 1994, U.S. officials advised Mexican officials on several occasions that they thought that their exchange rate policy was risky and indicated that they believed some sort of policy response was in order. However, as a senior Treasury official has testified, the U.S. ability to influence Mexico's economic policy decisions was limited because Mexico is a sovereign country. In addition,

it is not apparent from the evidence GAO reviewed that, at any time in 1994, U.S. officials believed they could argue with certainty that the peso was overvalued and that Mexico should devalue. U.S. officials were aware that investors in Mexican government securities perceived relatively small risks of a Mexican devaluation or default on its debts as measured by interest rates demanded on Mexican securities relative to interest rates for U.S. government securities. Furthermore, based on records that GAO reviewed and interviews with U.S. officials, the Federal Reserve and Treasury did not foresee the serious consequences that an abrupt devaluation would have on investor confidence in Mexico. These included a possible wholesale flight of capital that could bring Mexico to the point of default and, in the judgment of U.S. and IMF officials, require a major financial assistance package. One reason Treasury and Federal Reserve officials did not publicly reveal their concerns over Mexico's exchange rate system was that they were concerned that they might have provoked an immediate flight of foreign investment from Mexico.

IMF did not conclude that there was a major problem with Mexico's exchange rate situation during 1994. Although Mexico was repaying IMF loans, Mexico was not receiving new IMF financial assistance in 1994. This limited the amount of economic information that IMF was receiving on Mexico. In an annual country review completed in February 1994, IMF stressed the need for Mexico to lower its current account deficit. However, according to a Treasury official, IMF officials thought that Mexico's sizable exports meant there was not a need to adjust the foreign exchange policy. According to IMF and Treasury officials that GAO interviewed, IMF, like many informed observers, did not foresee the exchange rate crisis and, for most of 1994, did not see a compelling case for a change in Mexico's exchange rate policy.

U.S. and IMF Response to the Crisis

Although Treasury, the Federal Reserve, and IMF did not anticipate the magnitude of the peso crisis that unfolded in late December 1994, they soon concluded that outside assistance was required to prevent Mexico's financial collapse. Further, Treasury and Federal Reserve officials testified that the crisis threatened to spread to other emerging market countries. They also believed the Mexican crisis could undermine market-oriented economic reforms that the United States and IMF have urged those countries to adopt. In addition, Treasury and Federal Reserve officials were concerned that Mexico's financial crisis could escalate into a prolonged and severe economic downturn in Mexico that would put

important U.S. interests at risk—including trade, employment, and immigration.

Some observers argued that the United States should not have provided financial assistance to Mexico at all. They said that it was inappropriate for the U.S. government to place taxpayer funds at risk to prevent tesobono investors from incurring financial losses—even if not lending assistance meant Mexico would default on its short-term debts. In fact, they contended that supplying financial assistance to Mexico to pay off tesobono obligations could make future Mexico-like crises more likely, because it would create a “moral hazard” problem, i.e., it would encourage future investors in emerging markets to make riskier investments than they otherwise would have made because they would expect to receive U.S. government assistance during another crisis. Also, critics of U.S. financial assistance contended that the effect of Mexico’s crisis on other nations was either a temporary market overcorrection that would have reversed itself before seriously harming U.S. investors or other emerging markets or that it was an appropriate market correction because investors had overinvested in these markets in the first place. Lastly, some people argued that the threat a Mexican government default posed to U.S. trade, employment, and immigration was not sufficient to warrant U.S. financial assistance to Mexico.

At the beginning of January 1995, Mexico activated and drew down its \$6-billion short-term swap facility with the Federal Reserve and Treasury and its swap facility with the Bank of Canada. On January 12, 1995, the President announced a U.S. assistance package for Mexico consisting of loan guarantees of up to \$40 billion. Implementation of this initial assistance package required congressional approval. Although the bipartisan leadership of both houses of Congress endorsed the package, it ran into substantial congressional opposition.

Subsequently, on January 31, 1995, President Clinton announced a \$48.8-billion multilateral assistance package. Under this package, the United States would provide up to \$20 billion to Mexico through the use of ESF and the Federal Reserve swap network. The package was a combination of short-term swaps with renewals allowed, medium-term swaps of up to 5 years, and securities guarantees with terms of up to 10 years. These swaps and securities guarantees were conditioned on strict economic, financial, and reporting requirements. On February 1, 1995, IMF approved an 18-month standby arrangement for Mexico for up to \$17.8 billion. This arrangement, also conditioned upon Mexico’s adherence

to strict economic performance targets, was the largest financing package ever approved by IMF for a member country, both in terms of the amount and the overall percentage of a member's credit quota—in Mexico's case, 688.4 percent over 18 months (the usual cumulative limit is 300 percent). The primary purpose of the U.S., IMF, and other assistance was to allow Mexico to overcome its short-term liquidity crisis and thereby prevent Mexico's financial collapse.¹²

The government of Mexico has drawn on the international assistance offered by both the United States and IMF. As of December 22, 1995, \$13.5 billion in U.S. funds had been disbursed to Mexico under the support program. Of this amount, \$11.8 billion remained outstanding: \$1.3 billion in short-term swaps and \$10.5 billion in medium-term swaps. As of December 31, the United States had not extended any securities guarantees to Mexico. Through the end of 1995, Mexico had not missed any interest payments or required principal repayments under any of the swaps. As of December 31, ESF had received \$447.4 million in interest payments from Mexico for short- and medium-term swaps, and the Federal Reserve had received \$46 million in interest on its short-term swaps with Mexico. On January 2, 1996, \$242.4 million in interest was due to Treasury on the medium-term swaps; a Treasury official confirmed that that interest payment has been received. In early October 1995, Mexico prepaid \$700 million of the \$2 billion in swaps coming due October 30 anticipating the proceeds from a German mark-denominated bond issue. Mexico had also drawn \$13 billion from IMF by the end of December, none of which had fallen due or been repaid.

In connection with the implementation of the financial assistance package, the Secretary of the Treasury received two legal opinions that addressed his authority to use ESF. The Treasury General Counsel and the Department of Justice opinions both concluded that the Secretary had the requisite authority to use ESF to provide assistance to Mexico as contained in the support package. GAO has no basis to disagree with this conclusion.

Under the Gold Reserve Act of 1934, as amended, 31 U.S.C. § 5302, the Secretary of the Treasury has the authority to commit ESF funds if the commitment is consistent with IMF obligations of the U.S. government on orderly exchange arrangements and a stable system of exchange rates. The act gives the Secretary, with the approval of the President, the broad discretion to decide when the use of ESF is consistent with the IMF

¹²Other industrial countries, under the auspices of BIS, agreed to provide a short-term facility of \$10 billion, and Canada had already provided \$1 billion in December, under its Canada-Mexico swap arrangement.

obligations of the United States and states specifically that “the fund is under the exclusive control of the Secretary. . . .” 31 U.S.C. § 5302(a)(2). In the case of Mexico, the Treasury Secretary determined that the assistance package was consistent with U.S. obligations to IMF on assuring orderly exchange arrangements and promoting a stable system of exchange rates. Particularly, in this regard, IMF members agree to “seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.”¹³ In accordance with the discretion afforded him under the statute, the Secretary decided that the assistance package was consistent with these purposes because the Mexican financial crisis had had a destabilizing effect on the peso’s exchange rate and negative repercussions for the overall exchange rate system. In addition, IMF announced its own assistance package that served the same primary objective as did the U.S. assistance package.

To put the U.S. assistance package into place, the United States and Mexico entered into four financial agreements that provide Mexico with up to \$20 billion—the framework agreement, the oil agreement, the Medium-Term Exchange Stabilization Agreement (medium-term agreement), and the Guarantee Agreement, which are collectively referred to as “the agreements.” The agreements provide that Mexico may utilize up to \$20 billion of ESF resources in the form of short-term swaps, medium-term swaps, and securities guarantees. In order to have access to this funding, and during the period that any loans are outstanding, Mexico must satisfy certain economic, monetary, and fiscal conditions, as well as meet certain reporting requirements.

The short-term swap transactions may be provided in an aggregate amount of up to \$9 billion,¹⁴ through either the resources of the Federal Reserve or ESF, with maturities of up to 90 days. The Treasury and Mexico may enter into medium-term swap transactions with maturities of up to 5 years up to an amount that, when added to the amount of outstanding short-term swaps and guarantees, does not exceed \$20 billion. In connection with any medium-term swap transaction, Mexico is required to maintain the dollar value of peso credits to the United States, adjusting the amount of pesos on a quarterly basis, to reflect changes in the peso-dollar exchange rate. Finally, ESF funds may be used to guarantee the payment of all or part of the principal of and interest on debt securities denominated in U.S. dollars

¹³Article IV of the IMF Articles of Agreement.

¹⁴Under the framework agreement, short-term swaps are available from the Federal Reserve in an amount up to \$6 billion and from ESF in an amount up to \$3 billion.

to be issued by the government of Mexico. No guarantee may be issued with respect to principal or interest payments due more than 10 years after the date of issuance of the debt securities. The swaps and guarantees may be disbursed for a period of 1 year, with an optional 6-month extension, after the effective date of the framework agreement—February 21, 1995.

The interest rates applied to the short-term swaps are intended to cover the cost of funds to Treasury and therefore are to be set at the inception of each swap transaction based on the then-current 91-day U.S. Treasury bill interest rate. This is the same rate that the Federal Reserve and Treasury charge other countries for short-term currency swaps. As of August 1, 1995, the annual rate for short-term swaps was 5.45 percent.

Mexico is to be charged a higher interest rate for medium-term assistance that will be at least sufficient to meet the current U.S. government credit risk rating for Mexico. Interest charges, which are to be determined at the time of disbursement on the medium-term swaps, are to be designed to cover the costs of funds to Treasury plus a premium for the risk associated with the extension of funds. For each medium-term swap disbursement, the premium is to be the greater of (1) a rate determined by the U.S. government's Interagency Country Risk Assessment System (ICRAS) to be adequate compensation for sovereign risk¹⁵ of countries such as Mexico or (2) a rate based on the amount of U.S. funds outstanding to Mexico from short- and medium-term swaps and securities guarantees at the time of disbursement. The rates for medium-term swaps were 7.8 percent for funds disbursed in March, 10.16 percent for funds disbursed in April and May, and 9.2 percent for funds disbursed in July.

Under the guarantee agreement, Mexico is to pay to the Treasury Department a guarantee fee calculated using a present value formula. The variables in the formula include the amount to be guaranteed, the maturity of the debt securities, Treasury's borrowing rate for the same maturity, Mexico's cost of borrowing with the guarantee, and an appropriate credit risk premium, which is to be the greater of the ICRAS premium, or 225 to 375 basis points, depending on the total amounts outstanding. As an example, if the United States were to guarantee \$8 billion of debt securities issued by the government of Mexico, the agreement provides for

¹⁵Sovereign risk is the risk of default by a foreign central government or an agency it backs.

Mexico to pay the Treasury Department a guarantee fee of about \$1.9 billion.¹⁶

In circumstances such as the Mexican financial crisis, in which financial markets essentially ceased to function in terms of Mexico's access,¹⁷ markets cannot be relied on to provide a measure of the risk. GAO believes that the use of the ICRAS rate as a starting point, followed by adjustments, was a reasonable approach to establish the risk premiums.

The Treasury and Mexico entered into the oil agreement to help ensure that if Mexico defaults on its obligations, the United States will be repaid from oil export proceeds earned by Mexico's state-owned oil company, Petroleos Mexicanos (PEMEX). In Treasury's view, the oil proceeds payment mechanism, while not providing an absolute assurance of repayment, does provide the United States with a high degree of repayment assurance. According to Treasury officials, the current oil facility's reliability has been improved compared to oil facilities used in the past.

Under the oil agreement, proceeds from PEMEX's sales of oil to export customers are to be deposited into a special account at the Federal Reserve Bank in New York. Export customers have to acknowledge irrevocable payment instructions from PEMEX, and for the benefit of the United States, to deposit payments into PEMEX's account at a major international bank in New York. PEMEX has also irrevocably instructed this major international bank to transfer these payments into a special account of the Bank of Mexico at the Federal Reserve Bank of New York. The United States has a right of set-off¹⁸ against funds in the account if Mexico defaults on the assistance package.

The oil agreement does not require a minimum balance and, absent a default, proceeds should regularly flow out of the account to the Bank of Mexico. Since the initiation of the facility, Treasury records show that in any one day, an average of \$25 million to \$30 million has flowed into and

¹⁶This example assumes (1) a maturity for Mexican debt securities of 10 years, principal repayment at the end of 10 years, and interest payments annually; (2) an interest rate on the debt securities of 6.5 percent per year, comprising Treasury's cost of borrowing of 6.0 per cent plus a premium of 50 basis points to reflect the fact that these securities would be less liquid than U.S. Treasury bonds; and (3) a credit risk premium of 375 basis points.

¹⁷According to Bank of Mexico data, for three successive weekly auctions between December 27, 1994, and January 10, 1995, the quantity of bids fell far short of the amount of tesobonos offered at auctions for all maturities.

¹⁸Set-off clauses give the bank or lender a right to seize deposits owned by a debtor for nonpayment of an obligation.

out of the account. About \$6.8 billion flowed through the account during 1995. Under the terms of the agreement, there are no controls over the funds in the account if Mexico is current on all its obligations to Treasury, and money need not accumulate in the account even until the end of the day; at most, a single day of proceeds may be in the account.

Treasury officials maintain that the mechanism depends on the flow of funds following any default. They point out that the coverage provided by this flow is greater than outstanding obligations of Mexico to the United States. A threshold mechanism allows Treasury to require prepayment if export volumes or oil prices decline 15 to 25 percent from 1994 levels. Changes in future flows may affect the time needed for obligations to be repaid and Treasury would be compensated through late charges.

Consequently, a single day's flow would not be sufficient to cover a major default by Mexico. Once a default has occurred, the Federal Reserve Bank of New York has been authorized to use the funds in the special account to repay all amounts due and payable under the assistance agreements. The account could be used over time to cure a default provided that PEMEX continued to produce and export oil to the customers covered by the oil agreement. Changes in the world price of crude oil and petroleum products could affect the amounts of the deposits made and thus the time that would be needed to pay off any default. Because of these uncertainties, in GAO's view, the oil agreement by itself cannot be considered as providing a high degree of assurance that the United States will be repaid if Mexico defaults on its loans or guarantees, but considered in the context of the agreements implementing the assistance package, it does enhance the likelihood of repayment.

In assessing the likelihood of repayment, the other terms of the framework agreement should also be considered. Under the framework and related agreements, Mexico agreed to meet stringent economic conditions in return for U.S. and IMF assistance. These conditions provide the United States and IMF with a degree of influence over Mexican economic policy that did not exist before the onset of the financial crisis in December 1994. Thus the conditions in the agreements aim to increase the long-term likelihood that the United States will be repaid for the loans and securities guarantees. For example, as a result of the stringent conditions, Mexico's trade balance was transformed from a large deficit into a surplus during the first 6 months after the framework agreement was signed. This rapid turnaround has positive implications for Mexico's future ability to repay its debts.

Initial Efforts to Recover From the Crisis

The response to Mexico's financial crisis, including the U.S. and IMF assistance package, has had both positive and negative effects on Mexico. On the positive side, Mexico's current account deficit is projected by its Finance Ministry to decline to \$215 million in 1995, down from \$29.4 billion in 1994. The trade balance has moved to the surplus side. Mexico's merchandise trade surplus was \$6.1 billion for the first 10 months of 1995. By the end of August 1995, the outstanding balance of short-term, dollar-indexed Mexican government debt had been reduced by about 90 percent. Since the beginning of 1995, the amount of tesobonos outstanding has declined from \$29.2 billion to \$700 million at the end of November. Mexico's external debt has been restructured to be longer term. As of December 19, 1995, Mexico's stock market, in peso terms, was about 22 percent above precrisis levels and about 96 percent above its late February lows. Interest rates on short-term peso debt declined in August 1995 to about 34 percent, from a high of about 83 percent in March 1995, and were about 49 percent in December 1995.

These economic improvements were not made without hardship, however, and the economic measures taken by the Mexican government in conjunction with the U.S. and IMF assistance packages have had a severe impact on economic growth in the Mexican economy. Economic growth for 1995, which was forecasted at the start of the year by the Mexican government to show a decline of 2 percent for the year, has been much worse. After declining substantially in the first half of 1995, economic output in the third quarter contracted by 9.6 percent from the same period a year ago.

The positive developments are critical, since Mexico must restore the credibility of its economic policies so that it can regain access to international capital markets. There is evidence that Mexico has already reestablished some access. On May 4, 1995, Mexico's National Development Bank was able to sell bonds in an amount of \$110.3 million in international capital markets for 1 year at the London Interbank Offered Rate (LIBOR) plus 3.5 percent.¹⁹ On May 23, 1995, Mexico's export development bank was able to sell bonds in an amount of \$30 million in international capital markets for 1 year at LIBOR plus 5.8 percent. On July 20, 1995, Mexico issued \$1 billion in sovereign notes²⁰ for 2 years at LIBOR plus 5.375 percent in a private debt offering led by Citibank, Credit Suisse, and the Bank of Tokyo. The principal and accrued interest of these

¹⁹LIBOR is a key interest rate at which major banks in London are willing to lend to each other. It is often used as a benchmark rate in international financial transactions.

²⁰Sovereign notes are securities issued by countries.

notes may be converted into new capital in a newly formed or existing Mexican bank or tendered as payment for shares in any Mexican privatization. Other international issues have since followed.

The impact of Mexico's current recession on the financial condition of Mexico's banking system is still a matter of concern. Mexico's banks, which were reprivatized in 1991 and 1992, have not resolved all the problems brought with them from the time they were nationalized. Moreover, as part of the government economic plan for responding to the Mexican financial crisis, interest rates have risen significantly. The increased rates have contributed to an already high level of nonperforming loans. Delinquent loans as reported by Mexico rose from a 1994 rate of 9 percent of all bank loans to about 17 percent of all bank loans by the end of September 1995. However, Mexican banks define nonperforming loans differently than do U.S. banks. According to a World Bank official, the 17 percent reported by Mexico would equate to about 27 percent using U.S. generally accepted accounting principles. Many of the largest Mexican banks are looking to domestic and foreign investors for capital infusions.

The government of Mexico's response to banking system problems has several components. The Bank of Mexico provided dollar loans to banks to replace maturing foreign currency liabilities. These loans, which rose to as much as \$3.8 billion in the early months of 1995, have been repaid. Also, banks can recapitalize with subordinated debt issued to the government of Mexico that would either be retired by the banks within 5 years or converted to stock and sold to private investors by the government.²¹ In addition, the government has liberalized limits on foreign investment in Mexican banks. Another Mexican government initiative aims to restructure loans by indexing principal amounts to inflation so that interest payments can be based on real interest rates. In addition, the Mexican government, with the assistance of several sources including the World Bank, has been adding funds to its banking sector protection fund, which generally supports the banking system, and is seeking to improve its bank supervision capabilities.

Challenges Remain

Despite the progress to date, Mexico still faces many difficult challenges before its financial crisis can be fully resolved. Interest rates continue to be high, the peso continues to be volatile, and economic growth is weaker than predicted. For example, economic growth for 1995, which was

²¹Subordinated debt is repayable in a bankruptcy only after more senior debt has been repaid.

forecasted at the start of the year by the Mexican government to show a decline of 2 percent for the year, has been much worse. After declining substantially in the first half of 1995, economic output in the third quarter contracted by 9.6 percent from the same period a year ago. The banking sector remains strained, with nonperforming loans having risen to about 17 percent of all bank loans by the end of September 1995 as reported by Mexico, which would equate to 27 percent using U.S. generally accepted accounting principles, according to a World Bank official. Thus, it remains to be seen whether Mexico will be able to maintain economic policies that will allow the economy to recover from the crisis.

Agency Comments

GAO obtained written comments on a draft of this report from the Treasury Department and the Federal Reserve, who generally agreed with the report's description of the crisis and the U.S. response. On December 5, 1995, GAO met with State Department officials, including the Economics Officer from the Office of Mexican Affairs and Regional Issues, who generally agreed with the report. GAO also provided officials from the Bank of Mexico, Mexico's Finance ministry, the embassy of Mexico, and IMF with portions of the draft to confirm the accuracy of the presentation of information obtained from them.

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Abbreviations

APEC	Asia-Pacific Economic Cooperation
BIS	Bank for International Settlements
CIA	Central Intelligence Agency
CIEMEX-WESA	Centro de Investigaciones Econometricas de Mexico-Wharton Econometrics Forecast Associates
ESF	Exchange Stabilization Fund
EZLN	Zapatista Army of National Liberation (Ejercito Zapatista de Liberacion Nacional)
FOBAPROA	Mexico's deposit insurance agency (Fondo Bancario de Proteccion al Ahorro)
FOMC	Federal Open Market Committee
FRS	Federal Reserve System
G-10	Group of 10 industrialized nations
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
ICRAS	Interagency Country Risk Assessment System
IFC	International Finance Corporation
IMF	International Monetary Fund
IPC	Mexican Stock Index (Indice de Precios y Cotizaciones)
ITC	International Trade Commission
LIBOR	London Interbank Offered Rate
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
PAN	National Action Party (Partido Accion Nacional)
PEMEX	the national petroleum company (Petroleos Mexicanos)
PRD	Party of the Democratic Revolution (Partido de la Revolucion Democratica)
PRI	Revolutionary Institutional Party (Partido de la Revolucion Institucional)
PROCAPTE	Temporary Capitalization Program (Programa de Capitalizacion Temporal)
SDR	special drawing rights
TELMEX	the national telephone company (Telefonos de Mexico)
UDI	Loan Restructuring Program (Unidades de Inversion)

Introduction

Capital flows to developing countries have increased significantly in recent years. These increased flows have augmented the possibility that these countries will see growing financial instability as developing country governments and private sector firms increasingly rely on volatile capital investments that can be quickly withdrawn. Financial and trade reforms in Mexico in the early 1990s led to increased investor confidence. However, this confidence in Mexico evaporated at the end of 1994 and the beginning of 1995 as investors became more and more concerned about domestic Mexican political events and financial miscalculations. As a result, investors sold Mexican debt and equity securities, causing foreign currency reserves at the Bank of Mexico to be insufficient to meet the demand of investors seeking to convert their pesos to dollars. Mexico's financial crisis challenged the United States and the International Monetary Fund (IMF) to react and led to one of the largest multilateral economic assistance packages to any one country.

Changes in International Investing and Global Financial Markets

Due to a number of factors, including measures taken to open their economies to foreign investment, some developing countries¹ experienced significant inflows of capital during the early half of this decade. Capital flows² to these countries, which amounted to \$40 billion in 1990, reached a high of \$155 billion in 1993 before slowing to \$125 billion in 1994. Today, emerging markets account for 12 percent of total world equity market capitalization, and their economies are forecast to grow at about twice the rate of industrial countries over the period 1995 to 2000.³

In Western Hemisphere emerging markets, capital flows were more concentrated in yield-sensitive, liquid portfolios.⁴ These investments accounted for 66 percent of inflows to these markets between 1990 and 1994 compared to foreign direct investment,⁵ which represented 30 percent. Mexico experienced net capital outflows of \$15 billion in 1983

¹Emerging markets or developing countries are usually those whose production sector is dominated by agriculture and mineral resources and that are in the process of building up industrial capacity. We use the terms "emerging markets" and "developing countries" interchangeably.

²Capital flows include net foreign direct investment, net portfolio investment, and bank lending.

³See IMF, *International Capital Markets: Developments, Prospects, and Policy Issues* (Washington, D.C.: Aug. 1995).

⁴Portfolios are a set of assets held by an individual or institution. The term is generally used to refer to financial assets.

⁵Foreign direct investment implies that a person in one country has a lasting interest in and a degree of influence over the management of a business enterprise in another country. In some countries, a minimum percentage of domestic ownership of a foreign company is required.

through 1989, and net inflows of \$102 billion in 1990 through 1994. In 1993, Mexico received \$31 billion of capital inflows, which accounted for 20 percent of net capital flows to all developing countries. These increased capital flows to emerging markets were the result of several factors: (1) many developing countries restructured their commercial bank debt and implemented sounder macroeconomic policies as well as structural reforms in the 1980s and early 1990s, including financial sector reforms such as placing fewer restrictions on capital flows; (2) cross-border securities and banking transactions became less costly and more accessible; (3) institutional investors—mutual funds, insurance companies, pension funds, and banks and securities firms engaged in proprietary trading—diversified their portfolios internationally;⁶ and (4) interest rates fell in industrial countries, like the United States, thereby increasing the attractiveness of higher yields in emerging markets.

Past Economic Policy in Mexico

Policy decisions that Mexican financial authorities took in 1994 need to be considered in the context of Mexico's financial and economic history. From the mid-1970s through the late 1980s, Mexico had been caught in a destructive cycle of inflation and currency devaluations that had seriously set back the country's economic development. Curbing inflation and restoring sustained economic growth was one of the top priorities of the administration of President Carlos Salinas de Gortari (1988-94), and a stable exchange rate policy was seen as a key element in this effort.

Mexico's Exchange Rate Policy Before 1988

From 1954 until 1976, Mexico maintained a fixed peso/dollar exchange rate, at 12.5 pesos per U.S. dollar.⁷ This period coincided with an era of sustained economic development and low to moderate rates of inflation for Mexico. However, beginning in 1972 the value of the Mexican peso was increasingly undermined by rising fiscal and current account⁸ deficits and growing inflation. By September 1976, mounting balance of payments pressures and unbridled capital flight forced the outgoing administration of President Luis Echeverria (1970-76) to devalue the currency. By the end of the year, the currency was trading at 21 pesos per dollar. The devaluation was followed by serious adversities for the Mexican economy.

⁶In 1993, assets under management by pension funds, insurance companies, and mutual funds in major industrial countries were about \$13 trillion, with U.S. institutional investors accounting for more than two-thirds of this total.

⁷This is a nominal exchange rate. The nominal exchange rate of a currency is the actual rate at which one currency can be exchanged for another currency at any point in time.

⁸A country's current account measures its transactions with other countries in goods, services, investment income, and other transfers.

The year closed with an annual inflation rate of 60 percent, while the country sank into a severe economic recession.

Under the administration of President Jose Lopez Portillo (1976-82), the currency was allowed to depreciate⁹ further, to 27.25 pesos per dollar. During this period, booming oil revenues enabled the Mexican government to embark on an expansionary economic development policy, borrowing large sums from abroad. Strong economic growth achieved in the course of these years was marred by inflation rates that were high relative to those in the United States and mounting fiscal and current account deficits. In real terms, the currency gradually became overvalued.¹⁰

In 1982, the international price for oil fell, and Mexico's access to foreign borrowing diminished. Faced with dwindling foreign reserves and massive capital flight, once again an outgoing Mexican administration resorted to devaluation. This time, the peso was devalued by almost 500 percent against the dollar over the course of the year. The country was plunged into a disastrous economic and financial crisis. Inflation reached an annual rate of over 60 percent. A series of protest strikes and work stoppages paralyzed economic activity. The Mexican stock market plummeted. The Bank of Mexico (Mexico's central bank) ran out of foreign currency reserves, and in August, Mexico temporarily suspended repayment of principal on its foreign debt. In September, the banking system was nationalized, and strict exchange rate controls were put in place. By the end of the year, the peso was traded at 160 per U.S. dollar.

With the leadership of President Miguel de la Madrid (1982-88), Mexico adopted a dual exchange rate policy. A "controlled" exchange rate applied to merchandise trade and official debt service payments, and a "free" rate applied to other types of transactions. The controlled exchange rate was depreciated daily at the discretion of Mexican government authorities. Gradually, the controlled rate moved closer to the free rate. By the end of 1986, the two rates were quite close, at about 920 pesos per dollar.

⁹Depreciation is a decline in the value of one currency relative to another in foreign exchange markets. Devaluation is the downward adjustment in the official exchange rate of a nation's currency.

¹⁰A change in the real exchange rate of a currency takes into account the impact of both a change in the nominal exchange rate of that currency as well as the impact of inflation. For example, if over the course of a year the inflation rate in Mexico were 20 percent higher than the inflation rate in the United States, and the peso depreciated in nominal terms relative to the dollar by 20 percent, the real exchange rate of the peso would not change. However, if the inflation rate in Mexico were 20 percent higher than the United States, and the peso were to depreciate by only 5 percent, the real exchange rate of the peso would increase, or appreciate, by about 15 percent.

Under President de la Madrid, priority was given to repayment of the huge foreign debt accumulated during the previous administration. As a result of meeting its debt obligations, Mexico became a net exporter of capital. The economy was drained of vital financial resources, and economic development stalled. The devaluation and the debt service burden, both external and domestic, also placed heavy inflationary pressures on the economy. By the middle of 1987, Mexico faced an inflationary crisis, with prices increasing faster than the currency was depreciating. In November, the Bank of Mexico stopped intervening in the foreign exchange market, and the currency dropped to a new low of about 3,000 pesos per U.S. dollar. Again the Mexican stock market plunged, and annual inflation reached a rate of 159 percent.

Economic and Financial Reforms in Mexico Since 1988

Since 1988, the Mexican government has instituted comprehensive reforms in an effort to make its economy more open, efficient, and competitive. These reforms addressed both domestic and international restrictions that limited Mexico's economic growth. Domestically, these reforms included removing restrictions on foreign investment, privatizing many state-owned enterprises, and reducing inflation and government spending. Internationally, Mexico sought to reduce barriers and expand trade with the rest of the world. These reforms helped spur a dramatic increase in investments and capital inflows to Mexico.

Pacto Agreement Used Exchange Rate Stability as an Anchor to Control Inflation

Following the economic upheaval of 1987, Mexican authorities sought to promote a stabilization plan to break the spiral of inflation and devaluation that had plagued the country since the mid-1970s. Stabilization was undertaken within the context of a series of agreements between the government, labor, and business sectors to foster social consensus on an evolving package of economic reforms. These tripartite agreements, which came to be known collectively as the "Pacto," provided the framework for economic policy under the administration of President Salinas (1988-1994).

The Salinas administration followed a strategy of economic adjustment and reforms aimed at reducing the government's role in the economy and achieving stable-private sector-led economic growth. Although specific goals and provisions of the Pacto changed over the years, a commitment to pursue tight fiscal and monetary policies and agreement on price, wage, and exchange rate policies, remained consistent themes. Exchange rate stability was regarded as the anchor of the Pacto, because the

commitment to defend an exchange rate requires prudence in monetary and fiscal policy and provides a stable environment for investors concerned about currency risk.

Under the Pacto, from March through December 1988 the peso/dollar exchange rate was fixed. However, in 1989 the fixed exchange rate was abandoned in favor of a more flexible system that allowed a gradual depreciation of the peso relative to the dollar. This system, known as the "crawling peg," provided for an annual depreciation of the peso of 16.7 percent in 1989, 11.4 percent in 1990, and 4.5 percent in 1991.

Beginning in November 1991, the peso/dollar exchange rate was allowed to fluctuate within a band that widened daily. The ceiling of the band was allowed to increase daily to enable the peso to depreciate at a rate of 0.0002 new pesos per dollar daily, while the floor was maintained at 3.05 new pesos per dollar.¹¹ The annual depreciation rate in 1992 was approximately 2.9 percent. In October 1992, the ceiling of the band was adjusted, allowing a rate of depreciation of 0.0004 new pesos daily. This provided for a depreciation rate of approximately 4.5 percent in 1993. Thus, from the end of 1991 to August 1994, the new peso/dollar exchange rate depreciated from about 3.08 to about 3.24 pesos per dollar.

**Peso Appreciation
in Real Terms**

The Pacto strategy was successful in reducing inflation from an annual rate of 159 percent in 1987 to 8 percent by the end of 1993. However, while the rate of inflation was coming down in Mexico during these years, it was still well above the rate of inflation in the United States. Consequently, the peso/dollar exchange rate gradually appreciated in real terms, even though in nominal terms the peso had depreciated. The implications of this appreciation for Mexico's economy were subject to different views. Some economic analysts argued that by 1994 the peso had actually become somewhat overvalued and that a slight devaluation was necessary to spur economic growth. On the other hand, key Mexican financial authorities were not convinced that the peso was overvalued and pointed to the strong performance of Mexican exports as proof. The concept of currency devaluation had also become very unpopular in Mexico following the disastrous experiences of the 1970s and 1980s.

¹¹Since 1993, the Mexican currency has been officially designated the "nuevo peso" or new peso. One new peso is equal to 1,000 old pesos.

**Privatization of
Government Enterprises**

Under the Salinas administration, Mexico continued a process of divesting itself of various government-owned enterprises. As of November 1994, the number of state-owned enterprises had declined from 1,155 in 1982 when divestiture started, to 215 as of November 1994. During this process, several major institutions have been privatized, including 18 commercial banks and the telephone monopoly Telefonos de Mexico (TELME).

**Opening Foreign
Investment in Mexico**

In May 1989, Mexico established a new set of regulations governing foreign investment that eased restrictions on foreign ownership and investment in Mexico. The new regulations increased the range of investments available to 100-percent foreign ownership. Further, under certain conditions, the new regulations did not require investors to seek approval from the Mexican government. Throughout 1989 and early 1990, the government made adjustments in the regulations governing foreign investment in petrochemicals, state banking, and insurance. After the decision to reprivatize banks was formally announced in May 1990, restrictions on foreign ownership in financial institutions were relaxed. Stock brokerage houses, financial groups, and banks were allowed up to 30 percent foreign ownership.¹²

**Mexican Reforms
Increased Investment**

Mexico's financial reforms successfully generated international interest in Mexico in the early 1990s, attracting about \$93 billion in net capital inflows during 1990 through 1993, according to IMF. However, foreign capital inflows during this period were more heavily weighted to relatively liquid portfolio investment rather than to foreign direct investment. Portfolio investment during 1990 through 1993 constituted 60 percent of foreign capital inflows, compared to about 18 percent for foreign direct investment.

The private sector particularly benefited from the surge in capital inflows during the early 1990s. The Mexican Stock Market Law of December 1989 opened up access to Mexico's equity markets and resulted in large inflows of foreign capital. Before the 1989 law, the ability of foreigners to participate in Mexico's equity markets was restricted, and therefore foreign capital had amounted to about 6 percent of Mexico's equity market capitalization. However, due to liberalization and subsequent high returns on Mexican equity investments, equity markets attracted inflows of \$23 billion during 1990 through 1993. By the end of this period, nonresident investors accounted for 27 percent of the capitalization of the

¹²Nora Lustig, Mexico: The Remaking of an Economy, The Brookings Institution, Washington, D.C.

Mexican equity market. Private sector bond placements also benefited from increasing interest in Mexico, attracting \$14 billion during this period, according to IMF.

Trade Laws Were Liberalized

Mexico has taken several important steps toward relaxing its trade regime over the past decade by entering into both multilateral and regional trade agreements. Mexico initiated trade reform in mid-1985. By 1986, Mexico had initiated fundamental changes to its trade laws, which paved the way for their entry into the General Agreement on Tariffs and Trade (GATT).¹³ Before these reforms, more than 90 percent of domestic production was protected by a system of import licenses. By December 1987, measures were introduced to reduce overall tariff levels to a maximum of 20 percent. By 1988, the amount of domestic production protected by import licenses stabilized at about 20 percent.

Trade Agreements Were Signed

Over the past decade, Mexico has made significant advances in opening its borders to international trade. Before 1982, large portions of the Mexican economy were virtually closed to foreign competition because of the tariff and nontariff barriers that were in place. A major step toward opening its borders came in 1986, when Mexico became a full member of GATT. This step resulted in important reductions in the type of protection traditionally provided to domestic producers. In addition to joining GATT, Mexico also entered into several other multilateral and regional trade agreements that served to improve its trading relationship with other countries. Since 1992, Mexico has entered into several free trade agreements with other Latin American countries including Chile, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. Mexico has also taken important steps to improve its relations outside of Latin America. For example, in November 1993, Mexico joined the Asia-Pacific Economic Cooperation (APEC) Pact, which promotes open trade and economic cooperation in the Asia-Pacific region.

In April 1994, Mexico became the twenty-fifth member to join the Organization for Economic Cooperation and Development (OECD). OECD is a forum for the discussion of common economic and social issues

¹³Created in 1947, GATT was the primary multilateral agreement governing international trade and was founded on the belief that more liberalized trade would help economies of all nations grow. In 1994 GATT was replaced by the World Trade Organization. See The General Agreement On Tariffs And Trade: Uruguay Round Final Act Should Produce Overall U.S. Economic Gains (GAO/GGD-94-83a; GAO/GGD-94-83b, July 29, 1994).

confronting member countries.¹⁴ The OECD's fundamental objective is to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining financial stability and thus contributing to the world economy.

North American Free Trade Agreement (NAFTA)

On January 1, 1994, Mexico took another major step toward opening its markets as it joined the United States and Canada in initiating NAFTA. NAFTA created the world's largest free trade zone, with 380 million people producing nearly \$8 trillion worth of goods and services. NAFTA's broad goal is to improve productivity and standards of living through the free flow of commerce in goods, services, and investment capital throughout North America. To accomplish this, NAFTA provided for the gradual removal of tariffs and other barriers to trade and established principles designed to protect North American investors from arbitrary interference by governments. In addition, NAFTA established a comprehensive set of principles and rules governing trade and investment in financial services. Under NAFTA, U.S. financial services providers are to be granted access to Mexico and, in general, are to be accorded the same rights and protections as are Mexican institutions.¹⁵

NAFTA's First Year

According to the U.S. International Trade Commission (ITC), NAFTA's first year resulted in "vigorous" trade and investment expansion among the three participants. The Bank of Mexico also noted a "substantial increase" in the total trading volume between Mexico and its NAFTA partners. NAFTA's implementation resulted in the immediate elimination of duties on approximately one-half of U.S. exports to Mexico. Under NAFTA, Mexico launched a 15-year phase-out period during which Mexico is to reduce its remaining tariffs. Mexico also started removing the remaining barriers to trade in goods, services, and foreign direct investment.

¹⁴OECD members include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

¹⁵See North American Free Trade Agreement: Assessment of Major Issues (GAO/GGD-93-137 vols. 1 and 2, Sept. 9, 1993).

Objectives, Scope, and Methodology

Objectives

In response to a request from the Chairman of the House Committee on Banking and Financial Services, we (1) examined the origins of Mexico's financial crisis; (2) assessed the extent to which the U.S. government and IMF were aware of the severity of Mexico's financial problems and the extent to which they provided key financial advice to Mexico throughout 1994; (3) described the U.S. and international response to the crisis, which included providing an analysis of the statutory authority for the Secretary of the Treasury to use the Exchange Stabilization Fund (ESF)¹⁶ to finance the assistance package, and an assessment of the terms and conditions of the agreements implementing the U.S. portion of the assistance; and (4) described the initial efforts of Mexico to recover from the crisis, which included a discussion of Mexico's access to international capital markets.

Scope

To achieve these objectives, we reviewed documents and spoke with officials about

- risks in international finance;
- the history of financial assistance for Mexico;
- recent economic and financial reforms in Mexico;
- economic factors leading to Mexico's financial crisis including macroeconomic policy, exchange rate policy, foreign exchange reserves, debt financing, and current account balance;
- the awareness of Treasury, Federal Reserve, and State Department officials of Mexico's financial situation;
- advice given to Mexican government officials by Treasury, Federal Reserve, and State Department officials;
- political factors contributing to the loss of investor confidence in Mexico;
- the financial health of the Mexican banking system;
- U.S., IMF, Bank for International Settlements (BIS), and Canadian assistance packages, including the packages' legality, objectives, funding, and terms and conditions;
- criticisms of the U.S. assistance package;
- Mexico's post-crisis economic plan;
- implementation of the U.S. assistance package; and

¹⁶In the past ESF has been used to buy and sell foreign currencies, extend short-term swaps to foreign countries, and guarantee obligations of foreign governments. ESF's use must be consistent with U.S. obligations in IMF regarding orderly exchange arrangements and a stable system of exchange rates.

- the initial effects of the crisis on the Mexican economy and Mexico's ability to borrow on international capital markets.

Methodology

We reviewed documents collected from U.S. and Mexican government organizations, international organizations, and private firms. These documents included books, correspondence, legislation, memoranda, regulations, reports, cable traffic, and testimony. We received copies of or were given access to all U.S. government documents that were provided to the House of Representatives as required by U.S. House Resolution 80. House Resolution 80 required the executive branch to provide all documents relating to the U.S. assistance package, including documents relating to the status of the Mexican economy; contacts between the Mexican government and the Treasury Secretary or international lending organizations; disbursements from ESF; the legal basis for using ESF for this purpose; and assessments of the collateral offered by the Mexican government. These documents represented over 15,000 pages of information. We did not verify the accuracy of this information.

To review this vast amount of information, we developed categories in which to organize the information contained within each document. The categories were divided into three major sections: (1) background of the crisis, (2) the crisis of 1994-95, and (3) response to the crisis. Under "background of the crisis," we used the following categories:

- history of support,
- Mexican reforms,
- NAFTA, and
- miscellaneous background information.

Under "crisis of 1994-95," we used the following categories:

- political factors,
- investor confidence,
- investment flows,
- current account,
- foreign exchange reserves,
- peso valuation,
- macroeconomic policies,
- advice to Mexico,
- Mexican banks,

- past crisis comparisons, and
- miscellaneous crisis information.

We also reviewed documents listed in this report's selected bibliography and read related documents at the Central Intelligence Agency (CIA). Further, we attended several conferences focusing on Mexican economic issues. To prepare our legal analysis, we reviewed relevant U.S. government agency legal opinions and related agency documents, U.S. statutes, and legislative history. Information on foreign law in this report does not reflect our independent legal analysis but is based on interviews and secondary sources.

We interviewed U.S. government officials from

- the Federal Reserve System (FRS);
- the Department of State, both in Washington, D.C., and in the U.S. embassy in Mexico City; and
- the Department of the Treasury, both in Washington, D.C., and in the U.S. embassy in Mexico City.

We interviewed government of Mexico officials from

- Mexico's Finance ministry (Secretaria de Hacienda y Credito Publico),
- the Bank of Mexico,
- Mexico's Foreign ministry (Secretaria de Relaciones Exteriores),
- the Mexican Banking and Securities Commission (Comision Nacional Bancaria), and
- two government-sponsored development banks in Mexico (Banco Nacional de Comercio Exterior and Nacional Financiera).

We interviewed individuals from international organizations including IMF.

We interviewed international investors and investment experts from

- the Mexican stock exchange (Bolsa Mexicana de Valores),
- the Mexican Investment Board,
- the two largest commercial banks in Mexico,
- international and Latin American economic experts at universities and private research and consulting organizations,
- two U.S.-based global bond and equity funds with sizable investments in Mexico,
- seven U.S.-based investment and commercial banks, and
- one European-based bank.

We conducted our work between March and December 1995 in accordance with generally accepted government auditing standards.

Agency Comments

We obtained written comments on a draft of this report from the Treasury Department and the Federal Reserve, who generally agreed with the report's description of the crisis and the U.S. response. (See appendixes II and III.) Their suggested clarifications and technical changes have been incorporated in the text where appropriate. On December 5, 1995, we obtained oral comments on a draft of this report from State Department officials, including the Economics Officer from the Office of Mexican Affairs and Regional Issues, who generally agreed with our report. They suggested minor clarifications which have been incorporated as appropriate. We also provided officials from the Bank of Mexico, Mexico's Finance ministry, the embassy of Mexico, and IMF portions of the draft to confirm the accuracy of the presentation of information obtained from them. Their technical changes and editorial suggestions have been incorporated in the text where appropriate.

Origins of Mexico's 1994-95 Financial Crisis

The origins of Mexico's financial crisis can be found in the interplay of a number of complex economic and political factors during 1994. The market-opening reforms undertaken by the Salinas administration, coupled with its exchange rate policy, had led to an increase in foreign investment that helped finance an increase in Mexico's imports—resulting in an expanding current account deficit. A series of political developments and high-profile crimes during the early months of 1994 had weakened Mexico's image of stability and modernity among investors. These events culminated in the assassination of the leading presidential candidate, which provoked a massive loss of foreign reserves. After this tragedy, the government was temporarily able to stem the loss of foreign reserves. However, in an attempt to ensure economic growth during the months leading up to the presidential election, the government pursued macroeconomic policies that became increasingly inconsistent with its exchange rate policy and failed to deal with the current account deficit. Following the election, a new series of political shocks led to renewed capital flight, and eventually foreign reserves declined to the point that the authorities could no longer defend the established exchange rate through intervention.¹ Finally, in the process of the transition to a new government, the newly appointed team that was responsible for Mexico's financial affairs committed a series of key errors that contributed to the financial crisis.

Certain Weaknesses Emerged in Mexican Economy Toward End of the Salinas Administration

The reforms discussed in chapter 1 transformed the Mexican economy, but these market-opening alterations generated a new set of challenges for financial authorities toward the end of President Salinas' term in office. Mexico's mounting current account deficit, in particular, emerged as a troublesome issue for the Mexican economy during this period. The growth in the current account deficit, in turn, was closely linked to a decline in the private sector savings rate and a progressive real appreciation of the currency. In addition, Mexico's banking system, which had been reprivatized under Salinas, was fragile and was perceived as presenting a constraint on the use of monetary policy to support the peso or to bring down the current account deficit.

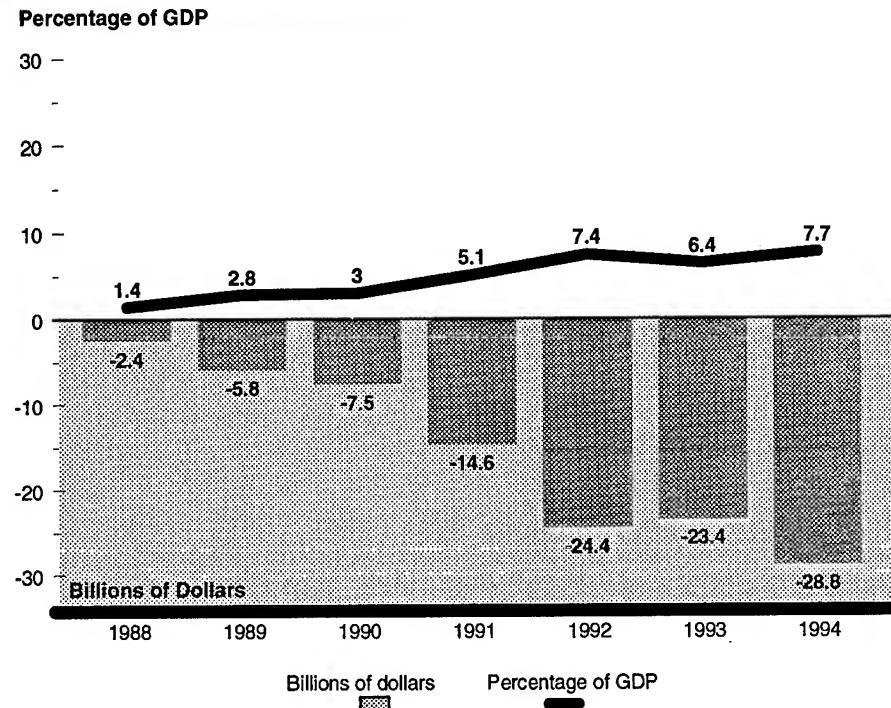
¹The exchange rate can be defended by a country in foreign exchange markets by a country's purchase of its own currency with its foreign exchange holdings or by other economic measures.

Mounting Current Account Deficits Accompanied Mexico's Opening to International Trade and Investment

Under the Salinas administration, Mexico sought to stimulate economic growth and competitiveness by encouraging international trade and investment. Certain economic indicators illustrate the effects of this strategy. Mexican merchandise exports almost doubled, from \$31 billion in 1988 to \$61 billion in 1994. Moreover, Mexico diversified its export base away from oil exports. During this period, the share of export earnings derived from oil products dropped from 21 percent to 12 percent. Mexico also attracted significant levels of foreign investment. According to the Bank of Mexico, from 1988 to 1994, Mexico drew in foreign investment amounting to \$102.8 billion, out of which \$30.2 billion was foreign direct investment. These high levels of investment allowed significant capital accumulation in the Mexican economy. During this time, foreign reserves increased from \$6.4 billion to \$24.5 billion. While these high levels of foreign investment allowed significant capital accumulation, they also fueled a boom in the Mexican stock market. There were also significant gains in productivity, which increased by an average rate of about 7 percent annually from 1988 to 1994.

However, these reforms entailed opening Mexico's own market to foreign products and by 1990, the total value of merchandise imports exceeded the value of Mexican exports. From 1990 to 1994, the country's annual trade deficit grew from about \$1 billion to \$18.5 billion. The large inflow of foreign investment capital financed a tremendous surge in private sector consumption. Consequently, Mexico's current account deficit grew from 1.4 percent of gross domestic product (GDP) in 1988 to 7.7 percent of GDP by 1994. (See fig. 2.1.)

Figure 2.1: Mexico's Current Account Deficit, 1988-94



Source: Bank of Mexico.

Mexican financial authorities told us that they were not alarmed by the mounting current account deficit. They noted that many countries with dynamic economies have sustained current account deficits for many years. They also called attention to the dynamic growth in Mexican exports and improvements in productivity over recent years, which suggested that the large current account deficit was a temporary situation that would be corrected in the long run.

Nevertheless, Mexico's current account deficit had grown particularly large in relation to its GDP,² and some financial analysts argued that such a

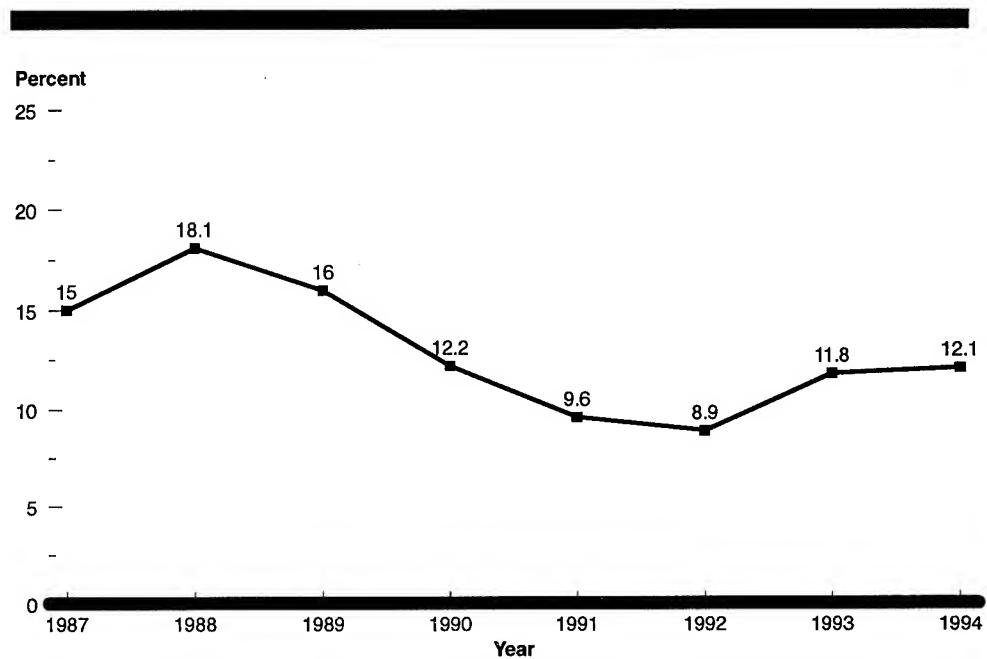
²Mexico's current account deficit as a percentage of GDP was very large for a developing country. For example, according to IMF data, Mexico's current account deficit from 1990 through 1993 averaged 5 percent of GDP. This figure is considerably higher than those of other large Latin American economies. Argentina had current account deficits averaging 1.9 percent of GDP, while Brazil had an average current account surplus of 0.1 percent.

high deficit could not be sustained over the long run. These analysts pointed out that Mexico's current account deficit was financed by the large influx of foreign capital. During the period 1990 to 1993, foreign capital was predominantly portfolio investment in Mexican stocks and bonds, rather than direct investment in fixed assets, such as factories. Portfolio investment is more liquid than direct investment and can be more easily withdrawn by investors. Consequently, the large current account deficit made the Mexican economy particularly vulnerable to investors' willingness to maintain their assets in Mexico. If financial markets' perception of Mexico changed, and investors withdrew their capital, the country would encounter difficulties in financing its current account deficit.

Decline in Mexican Private Savings Added Pressure on Current Account Deficit

According to the World Bank and other economic analysts, a key factor that contributed to Mexico's burgeoning current account deficit was the decline in the country's private domestic savings. As economic reforms proceeded during the early 1990s, Mexicans began shifting more of their income from savings to consumption. According to Bank of Mexico data, the private sector savings rate, which had been around 16 percent in 1989, had declined to less than 9 percent by 1992 and had only risen to around 12 percent by 1994. However, in spite of the decline in private domestic savings, a Bank of Mexico official noted that foreign investment allowed a substantial capital accumulation during the early 1990s. (See fig. 2.2.)

Figure 2.2: Mexico's Private Domestic Savings Rate as a Percentage of GDP, 1987-94



Source: Bank of Mexico.

Several explanations have been advanced by economists for the shift from savings to consumption, including (1) pent-up demand after years of austerity during most of the decade of the 1980s and (2) the attraction of cheaper foreign products that became available as Mexico opened its markets. In any event, the decline in domestic savings was reflected in increased demand for imports, which put additional pressure on the current account deficit. Moreover, imports were directed toward consumption rather than investment. This made the current account deficit even less sustainable because less was being invested for long-term growth.

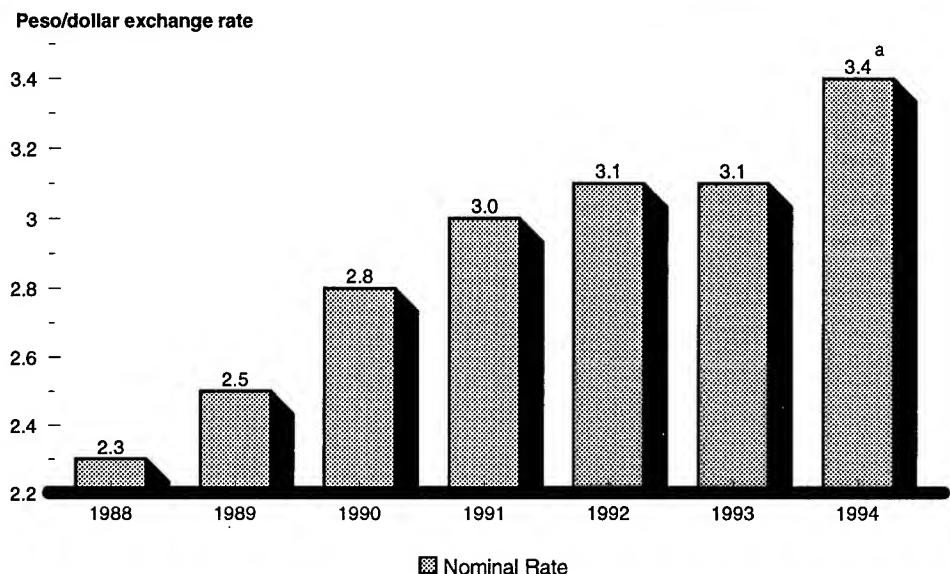
Current Account Deficit Deteriorated as Peso Became Increasingly Overvalued

As noted in chapter 1, exchange rate stability was regarded as the anchor of the Pacto. Thus, from 1988 through the end of 1994, the Mexican government pursued an exchange rate policy that sought to provide this stability. It did so by initially fixing the peso/dollar exchange rate and subsequently allowing a controlled nominal depreciation of the peso

against the dollar. Through most of this period, the government's exchange rate policy was successful in restoring economic stability, attracting foreign investment, and reducing inflation. However, certain economists outside Mexico began to argue that this strategy had also led to a progressive overvaluation of the currency, restricted export expansion, and stifled growth.

According to these economists, one reason for the progressive overvaluation of the peso was that the nominal depreciation allowed by the Mexican government over this period fell short of the inflation differential between the United States and Mexico. Although the rate of inflation was declining in Mexico during these years, it was still well above the rate of inflation in the United States. Consequently, the peso/dollar exchange rate gradually appreciated in real (inflation-adjusted) terms, even though the peso had depreciated in nominal terms. With an overvalued peso, Mexicans demanded more imports than they would otherwise have been able to afford. Conversely, even though Mexican exports experienced one of the highest rates of growth worldwide, these economists argued that the overvalued peso limited the growth exports would otherwise have enjoyed. Thus, the progressive appreciation of the peso and its overvaluation over this period led to further deterioration of the current account deficit. (See figs. 2.3 and 2.4.)

Figure 2.3: Average Annual
Peso/Dollar Exchange Rate, 1988-94

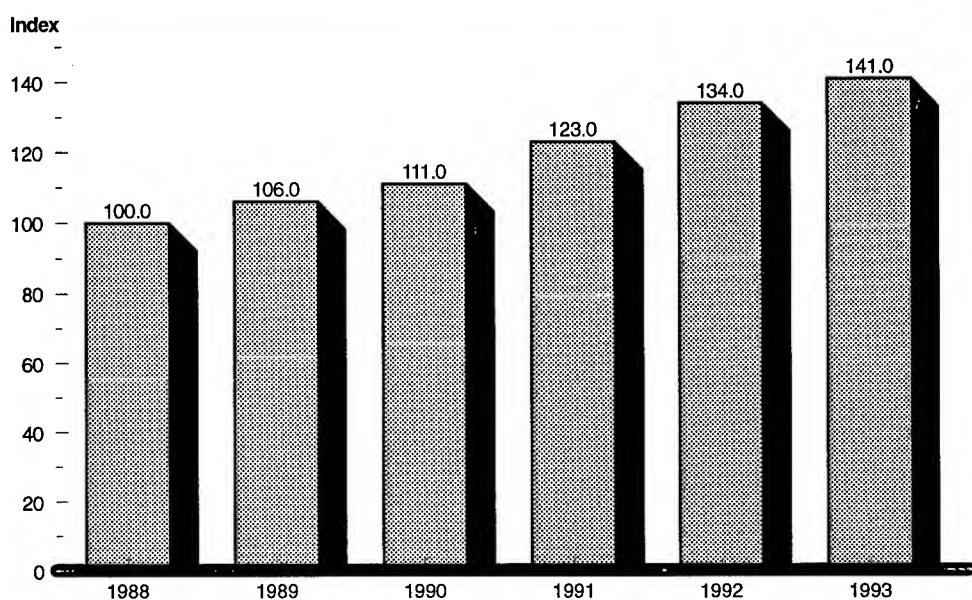


Note: All exchange rates are expressed in terms of new pesos. Exchange rates from 1988 to 1992 were converted from old pesos to new pesos. Old pesos were valued in 1,000's/dollar.

^aThe peso/dollar exchange rate on December 31, 1994, was 5.325.

Source: Bank of Mexico.

Figure 2.4: Real Peso/Dollar Exchange Rate Index, 1988-93



Note: The base year is 1988. This index shows the percentage increase in the peso value of the dollar when the nominal exchange rate has been adjusted for inflation in both Mexico and the United States. For example, the real peso/dollar exchange rate was 41 percent higher in 1993 than in 1988.

Source: CIEMEX-WESA.

In mid-1994, two economists argued that Mexico needed to take action to adjust the exchange rate to compensate for the overvaluation of the peso.³ A 20-percent devaluation of the exchange rate would have reduced the current account deficit to more manageable levels. However, according to Treasury officials, this view was not shared by many private economists who thought that only a small adjustment in the exchange rate was needed. Mexican financial authorities explained to us that they were not convinced that the peso was overvalued at that time. They cited as evidence the strong performance of Mexican exports and productivity gains.⁴ Some Mexican officials also noted that the concept of currency

³See Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization, Reform, and No Growth," *Brookings Papers on Economic Activity* (Washington, D.C.: The Brookings Institution, 1994).

⁴See Banco de Mexico, *Report on Monetary Policy: January 1, 1995 -December 31, 1995*, January 1995, pp. 11-14.

devaluation had become very unpopular in Mexico following the disastrous experiences with devaluations in 1976, 1982, and 1987. Thus, the Mexican government was not prepared to consider calls for a devaluation.

**Concern for Fragile
Banking System Precluded
Using Monetary Policy to
Reduce Current Account
Deficit**

Mexican private and government sources agree that following the nationalization of banks in 1982, commercial banks in Mexico had become somewhat inefficient due to a lack of competition within the financial sector. A Bank of Mexico official told us that although they were denationalized, commercial banks lacked appropriate risk evaluation systems to assess loans. He also noted that bank loans were biased in favor of consumer credit, which had exploded after 1989. This combination had led to a high ratio of overdue loans in commercial banks' portfolios. IMF documents show that as the banks were being privatized, the ratio of overdue loans had been increasing. Thus, the percentage of past due loans increased during December 1991 to March 1994, from 3.5 percent to 8.5 percent. This deterioration in the quality of assets weakened the banks.

According to Bank of Mexico officials, the fragile state of Mexican commercial banks during 1994 presented a serious challenge to financial authorities' ability to use monetary policy to decrease the current account deficit.⁵ One Bank of Mexico official told us that the decision not to increase interest rates beyond a certain point was undertaken in large measure to protect Mexico's weak, newly privatized commercial banks at a critical point in their development. The situation facing commercial banks in the spring of 1994 was exacerbated by the slowdown in the Mexican economy in 1993, which had increased the ratio of nonperforming (past due) loans in their portfolios. Due to the large ratio of nonperforming loans, Mexican commercial banks in 1994 were charging interest rates about 15-20 percentage points above the interest rate on "cetes" (cetes provide the benchmark 28-day interest rate for Mexico).⁶ If interest rates for cetes were allowed to increase too much, however, there was a risk of increasing the ratio of nonperforming loans for commercial banks because most commercial bank loans in Mexico have variable interest rates. According to this Bank of Mexico official, this was a situation Mexican financial authorities wanted to avoid because it could have threatened the viability of the entire commercial banking system.

⁵Contractionary monetary policy, which raises interest rates, causes a decrease in demand for imports, which can lead to a decrease in the current account deficit.

⁶Cetes are short-term, peso-denominated, Mexican government treasury certificates.

Political Developments During Early 1994 Raised Concerns About Mexico's Stability

While the Mexican economy underwent a process of comprehensive economic reform during the late 1980s, Mexico's political system was basically unaltered under the Salinas administration. However, as the 1994 presidential elections approached, the government came under increasing pressure from opposition parties, reform elements within the ruling party, and other critics to undertake reforms in the country's electoral system that would allow a fair and open election. The beginning of 1994 also coincided with a guerrilla uprising in the southern state of Chiapas. The guerrillas demanded political and social reforms to address the grievances of the local rural population. The course of the presidential elections, the uprising in Chiapas, and two high-profile kidnappings committed during the early part of 1994 set the stage for a heightened level of anxiety among investors about Mexico's overall and long-run political stability.

Institutional Revolutionary Party's (PRI) Control of Electoral Process Criticized by Opposition

Widespread concerns about Mexico's presidential elections centered on whether the governing PRI, which had ruled Mexico for over 60 years, would allow the conduct of fair and open elections. Following past presidential elections, questions had been raised regarding PRI's control over and manipulation of the electoral process. Opposition parties had become particularly strident in their charges of electoral fraud after the election of President Salinas in 1988, which PRI had won by a very narrow margin.

Chiapas Rebellion Damaged Mexico's Image

On January 1, 1994, armed guerrillas of the Zapatista Army of National Liberation (EZLN)⁷ seized several towns in the southern Mexican state of Chiapas, demanding "true democracy" and attention to issues affecting the local peasant population. The attack was timed to coincide with the entry into force of the NAFTA agreement. The uprising was a significant blow to Mexico's image as a stable and mostly conflict-free modernizing country seeking to join the developed world by enacting economic reforms and by joining NAFTA. (See fig. 2.5.)

⁷The rebels took the name of Emiliano Zapata, a peasant leader of the 1910 Mexican Revolution who had called for land reform.

Figure 2.5: Selected Political and Economic Events, January 1994 - March 1994

	Political events	Economic events
January '94	<p>1 Chiapas rebellion erupts - EZLN rebels seize several towns in the state of Chiapas.</p> <p>12 President Salinas fires Interior minister and replaces him with Jorge Carpizo.</p>	<p>1 NAFTA is initiated.</p>
February '94		<p>31 Mexico's end-of-month foreign currency reserves are \$26.3 billion.</p> <p>4 U.S. Federal Reserve increases interest rates from 3.00% to 3.25%.</p> <p>28 Mexico's end-of-month foreign currency reserves are \$29.2 billion.</p>
March '94	<p>14 Prominent banker is kidnapped.</p> <p>23 PRI presidential candidate Colosio is assassinated.</p> <p>29 Ernesto Zedillo is designated as the PRI's presidential candidate.</p>	<p>24 U.S. Federal Reserve increases interest rates from 3.25% to 3.50%.</p> <p>Temporary swap facility with the United States and Canada is announced. Mexican stock market closed for the day.</p> <p>26 United States, Mexico, and Canada announce formation of North American Financial Group.</p> <p>31 Mexico's end-of-month foreign currency reserves fall to \$24.4 billion. Interest rate on 28-day cetes averages 9.9% for first quarter of 1994.</p>

Source: GAO analysis.

The Mexican government responded to the uprising by sending federal troops to Chiapas. The government also sought to negotiate a quick settlement of the conflict. In mid-January, the Mexican Congress passed legislation granting amnesty to anyone involved in violence to that date. President Salinas also replaced the Interior Minister, a former governor of Chiapas, with a respected human rights advocate, Jorge Carpizo. Notwithstanding these conciliatory moves, EZLN held out for government

compliance with all of the movement's conditions. Both sides agreed to a cease-fire, but the region remained tense throughout 1994.

Meanwhile, some EZLN proposals resonated among other sectors of Mexican society, and various groups announced support for the movement's demands. On January 27, in an effort to deal with these broader political issues, the government and eight political parties agreed on a Pact for Peace, Justice, and Democracy, which included a proposal for electoral reform. The principal elements of the electoral reform program were to create independent electoral authorities, provide all parties with more equitable access to the media, and prohibit the use of public resources by any one party. In a separate action, the electoral tribunal of Mexico reduced the maximum allowable presidential campaign expenditure by each party from \$220 million to \$43 million. The newly appointed Interior Minister was charged with overseeing electoral reforms and assuring the fair conduct of presidential elections.

High-Profile Kidnappings Raised Additional Concerns

Investor concerns regarding Mexico's political stability were also raised during this time by the kidnapping of two prominent businessmen. On March 14, 1994, the head of Mexico's largest banking group (Banamex-Accival) was kidnapped and held for an undisclosed ransom. Following this incident, the Mexican stock market fell 81 points, apparently out of fear that the kidnapping was linked to the Chiapas uprising or had some other political motivation. The businessman was released on June 28, 1994, following reports that a high ransom had been paid. On April 25, another wealthy businessman was kidnapped in Mexico City. Following this abduction, President Salinas attempted to calm the fears of the business community and investors by creating a new agency to coordinate public security. The businessman was eventually released on August 5, 1994.

Capital Flight Caused by Political and Economic Events

Mexico's large current account deficit had placed the economy in a vulnerable position, subject to investors' willingness to maintain their assets in the country. However, political developments during the early part of 1994 had begun to raise doubts about Mexico's long-term stability. The situation came to a head on March 23, 1994, when PRI's presidential candidate, Luis Donaldo Colosio, was assassinated while campaigning in Tijuana. Following the assassination, Mexico experienced large losses in foreign exchange reserves. In response to this crisis, the Mexican government adopted a strategy to stabilize foreign reserves in the short

run and sought financial support from its North American Free Trade Agreement (NAFTA) partners. The government's strategy succeeded in bringing temporary stability to the economy, but political uncertainty continued.

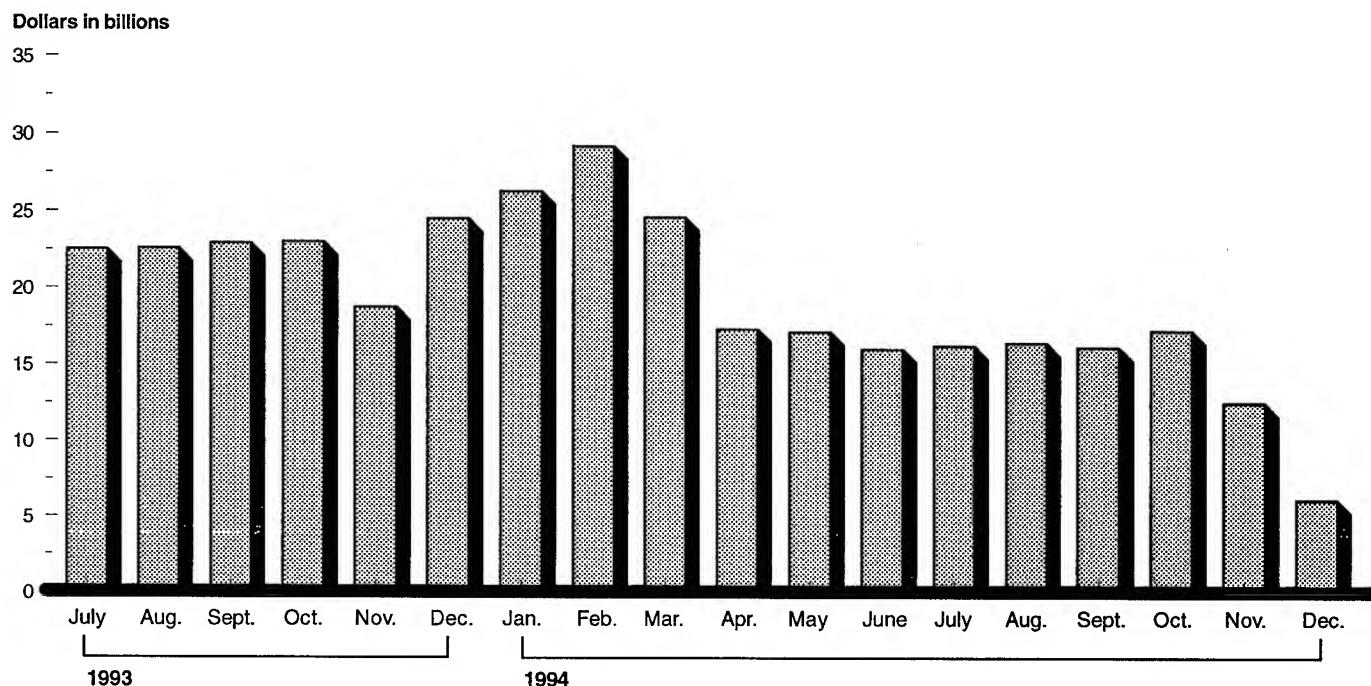
Financial Markets Reacted Adversely to Colosio's Assassination

The murder of such a high-level political figure as Colosio was unprecedented in recent Mexican history.⁸ As the PRI candidate, Colosio had been the front-runner in the presidential race and was almost certain to have become president. Colosio's assassination, in conjunction with continuing unrest in the state of Chiapas and concerns about other criminal acts discussed previously, led to fears of political turmoil in Mexico.

Financial markets reacted immediately. On March 24, President Salinas, concerned about a run on the peso and the drop in the stock market, appealed for calm. He then closed banks, currency exchange houses, and the stock market. This same day, the Federal Reserve and Treasury announced the availability of a large temporary swap facility. Nevertheless, the stock market closed down 22 points on the following day. There was a net outflow of capital in April and a dramatic loss in foreign reserves. By April 22, barely a month after Colosio's assassination, foreign reserves had declined by \$10.8 billion. (See figs. 2.6 and 2.7.)

⁸The last high-level political assassination in Mexico was that of President Alvaro Obregon in 1928.

Figure 2.6: Mexico's Foreign Exchange Reserves, July 1993 - December 1994



Note: End-of-month data.

Source: Bank of Mexico.

Figure 2.7: Selected Political and Economic Events, April 1994 - June 1994

	Political events	Economic events
April '94	<p>25 The vice-chairman of Grupo Gigante, a large Mexican retailer, is kidnapped.</p>	<p>1 Bank of Mexico is granted greater degree of autonomy in making monetary policy.</p> <p>14 Mexico is admitted as a member of OECD.</p> <p>18 U.S. Federal Reserve increases interest rates from 3.50% to 3.75%.</p> <p>26 Trilateral swap facility announced.</p> <p>30 Mexico's end-of-month foreign currency reserves are \$17.3 billion.</p>
May '94		<p>17 U.S. Federal Reserve increases interest rates from 3.75% to 4.25%.</p> <p>31 Mexico's end-of-month foreign currency reserves are \$17.1 billion.</p>
June '94	<p>24 Interior Minister Carpizo threatens to resign.</p>	<p>30 Mexico's end-of-month foreign currency reserves are \$16 billion.</p>

Source: GAO analysis.

U.S. Interest Rates Influenced Performance of Mexican Financial Markets

Before the Colosio assassination, the Bolsa was already experiencing some volatility. The Bolsa, which is generally tracked by its published index, the Indice de Precios y Cotizaciones (IPC), reached a high of 2,881 on February 8, 1994. In mid-February, however, the Bolsa began to decline. IMF reported that in February 1994, there was a net equity inflow of \$280 million from the United States. However, in March, U.S. investors sold a net \$170 million of Mexican shares, which accompanied a rapid stock price decline in Mexico. The Bolsa stock index continued to decline after the assassination before sliding to its 1994 low on April 20 of 1,957.

This was a decline of 37 percent in dollar terms from the February 8 high.
(See fig. 2.8.)

Figure 2.8: Mexico's Stock Market Index, January 1994 - October 1995

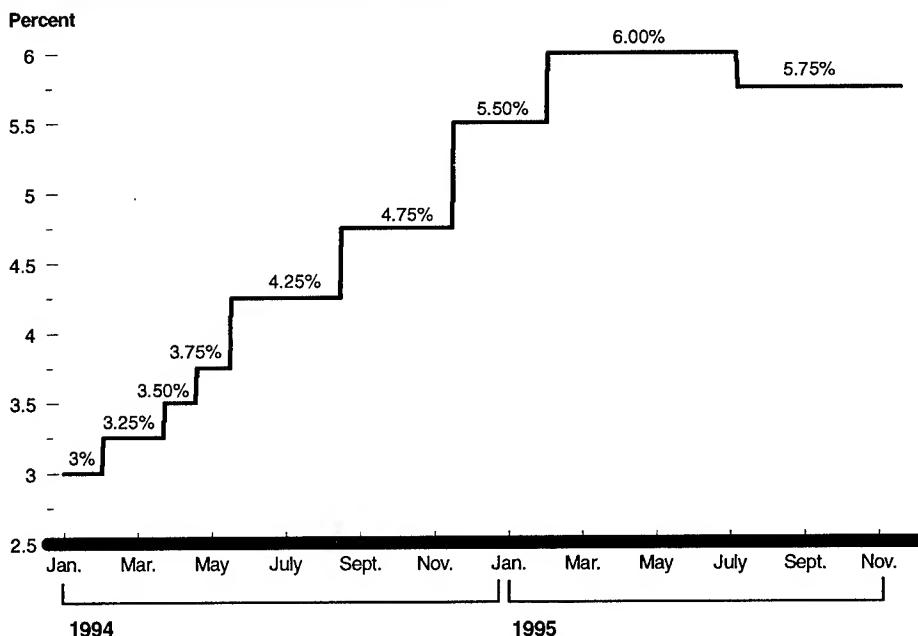


Source: Mexico's Bolsa (stock market).

Market analysts have noted that although Mexico should have anticipated a decline in the Bolsa after Colosio's assassination, investors were more influenced by economic events than by the tragedy. For example, a U.S. Treasury memorandum reported, at the time, that rising interest rates in the United States were likely to have a more profound effect on Mexican markets than was the political uncertainty caused by the assassination, a view with which many market analysts concurred. Early in February, the U.S. Federal Reserve had announced the first of six increases in interest rates that were to occur during 1994. Mexican stocks reacted badly to the news, as investors reassessed their Mexican holdings in light of Mexican

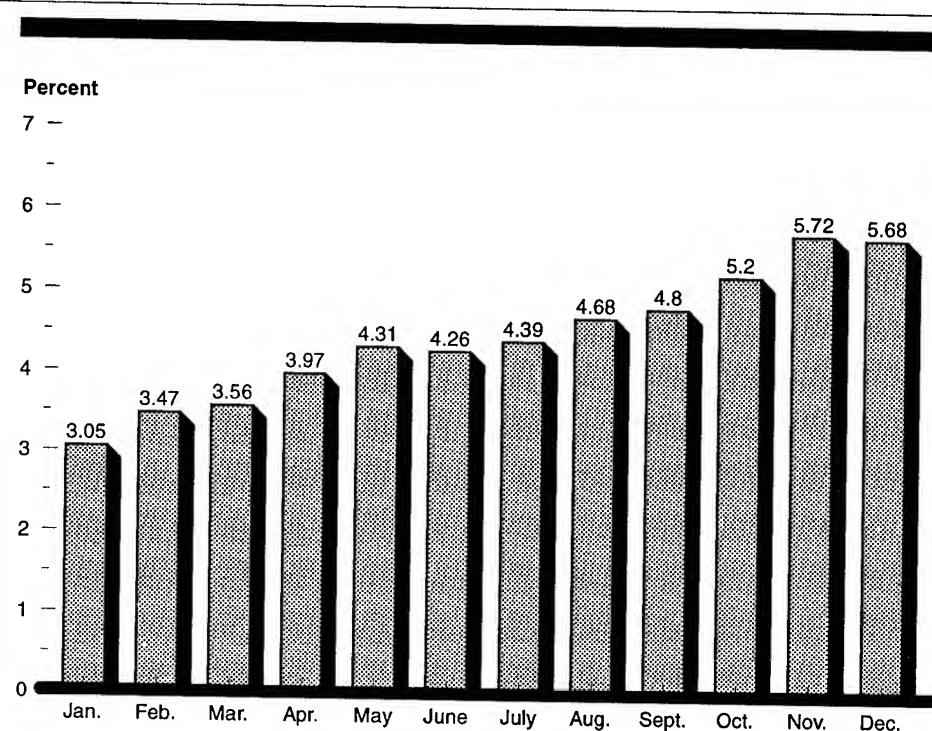
interest rates, an anticipated real GDP growth rate of only 0.4 percent, disappointing company earnings reports, and increasing political uncertainty, according to the Federal Reserve's staff analysis. Federal Reserve officials told us that Mexican financial officials failed to anticipate and react to developments in U.S. monetary policy. These officials also told us that Mexican authorities made a major mistake when they did not increase interest rates in anticipation of or immediately after the Federal Open Market Committee (FOMC) raised the federal funds rate 75 basis points on November 15, 1994. (See figs. 2.9 and 2.10.)

Figure 2.9: U.S. Federal Funds Rates, January 1994 - November 1995



Source: U.S. Federal Reserve.

Figure 2.10: Interest Rates for 3-Month U.S. Treasury Bills, January 1994 - December 1994



Note: End-of-month data.

Source: U.S. Treasury Department.

At the time, investors did not have access to a reliable futures or forward market to hedge against currency risk,⁹ because Mexico did not permit the trading of peso futures. According to a Bank of Mexico official, peso futures trading was attempted in the early 1980s, but the Bank of Mexico was concerned about peso price volatility. The Bank of Mexico thought that the market was not serving legitimate hedging interests and that banks were manipulating the market in a speculative manner. The effect of this absence of a futures market in Mexico, given the difficulty in hedging forward positions, heightened the perceived risk of investing in Mexico and negatively affected investor confidence, according to a 1995 Federal Reserve memorandum.

⁹In either a currency futures or forward market, the future price of the currency is established at the time of the contract.

In Response to Crisis, Mexican Government Took Action on Various Fronts and Obtained Support From NAFTA Partners

In the aftermath of the Colosio assassination, Mexican authorities undertook several measures to stabilize financial markets. To begin with, the Bank of Mexico allowed the peso to continue to rise to the ceiling of the exchange rate band.¹⁰ Although this action did not violate the commitment to exchange rate stability, it allowed for a significant depreciation in the value of the peso. Thus, by April 22, the peso was nearly 8-percent lower against the dollar than in it was in mid-February. The effect of this depreciation of the peso within the band was to increase the price of imports and relieve pressure somewhat on the current account deficit.

The government of Mexico also undertook changes in monetary policy. Interest rates offered for the benchmark 28-day cetes rose from 9 percent on March 23 to 18 percent by April 20. Mexico's Finance ministry offered higher interest rates on cetes to attract foreign investment and offset losses in foreign reserves. In addition, the government offered foreign investors more dollar-indexed, short-term securities, known as "tesobonos."

Although cetes carried exchange rate risk for dollar-based investors, tesobonos were dollar-linked and therefore carried no such exchange rate risk. This linkage to the dollar meant that at the time of maturity, tesobonos could be redeemed in pesos for whatever their original value was in dollar terms plus their interest earnings. Because the value of tesobonos was linked to the dollar, foreign investors were spared the foreign exchange risk inherent in holding cetes as long as they could also be sure that they had little risk of not being able to convert the pesos into dollars at the prevailing exchange rate. Mexico could therefore offer much lower interest rates for tesobonos than for cetes. For example, on April 20, 1994, the interest rate offered on 91-day tesobonos was only 6.6 percent, compared to 18 percent for cetes. During the period following the Colosio assassination, Mexican authorities began shifting the composition of the country's short-term internal debt from cetes to tesobonos. Thus, on the last week of April, there was nearly a sevenfold increase in tesobonos offered and a 57-percent reduction in cetes.

On April 26, 1994, U.S., Canadian, and Mexican monetary authorities announced an expanded trilateral "swap" facility to expand the pool of potential resources available to monetary authorities of each country to

¹⁰By allowing the peso to rise to the ceiling set by the exchange rate band, the authorities were in effect providing for a depreciation of the peso against the dollar. Most of the depreciation within the band that occurred after February took place before the Colosio assassination.

maintain orderly exchange markets.¹¹ The swap arrangement was established in connection with the newly formed consultative group called the North American Financial Group and comprised the finance ministers and central bank governors of Canada, Mexico, and the United States. Negotiations on a swap arrangement, totaling U.S. \$6 billion and Canadian \$1 billion, were begun in late 1993 but were only formally concluded on April 26, 1994. The swap arrangement was to be permanent, and the Federal Reserve was to provide \$3 billion and Treasury's ESF, the other \$3 billion. By announcing the swap arrangement, the NAFTA partners demonstrated confidence in Mexico's economic policies, expanding the pool of potential resources available to Mexican authorities to maintain order in financial markets. The Federal Open Market Committee saw the announcement as an action that would help confirm continued U.S. support for Mexico's economic policies at a potentially critical time for Mexican financial markets. Although initial multilateral discussions of the swap arrangement predated the Colosio assassination, and the swap arrangement was originally intended as a complement to NAFTA, the April announcement of the swap facility may have helped to relieve pressure on the peso/dollar exchange rate.

Concerns Raised About Outcome of Presidential Elections

A month after the assassination of Colosio, Mexican authorities had been largely successful in stabilizing financial markets. Still, political uncertainty continued in the period leading up to the elections. Colosio's assassination raised new questions about the course and outcome of the 1994 presidential elections. For example, press reports speculated about PRI's ability to find a viable candidate so close to the elections. A complex set of conditions, including restrictions regarding past government service and place of residence, ruled out many potential candidates. Eventually, Ernesto Zedillo, Colosio's campaign manager, was designated as PRI's new presidential candidate. However, according to press reports, Zedillo lacked political experience and initially had difficulty attracting public support.

Controversy about the course of the elections and reforms continued throughout the summer. In June, Interior Minister Carpizo resigned, only to be reinstated after appeals from PRI and other political parties. His resignation was followed by a temporary decline in foreign reserve levels.

¹¹A swap arrangement provides for temporary exchanges of currencies between participating countries. Partners in the arrangement can draw on each other's currency by supplying their own currency up to an agreed amount. The swap is usually reversed within a short period at the original exchange rate, but may be rolled over.

Inconsistencies Developed in Mexican Macroeconomic Policies

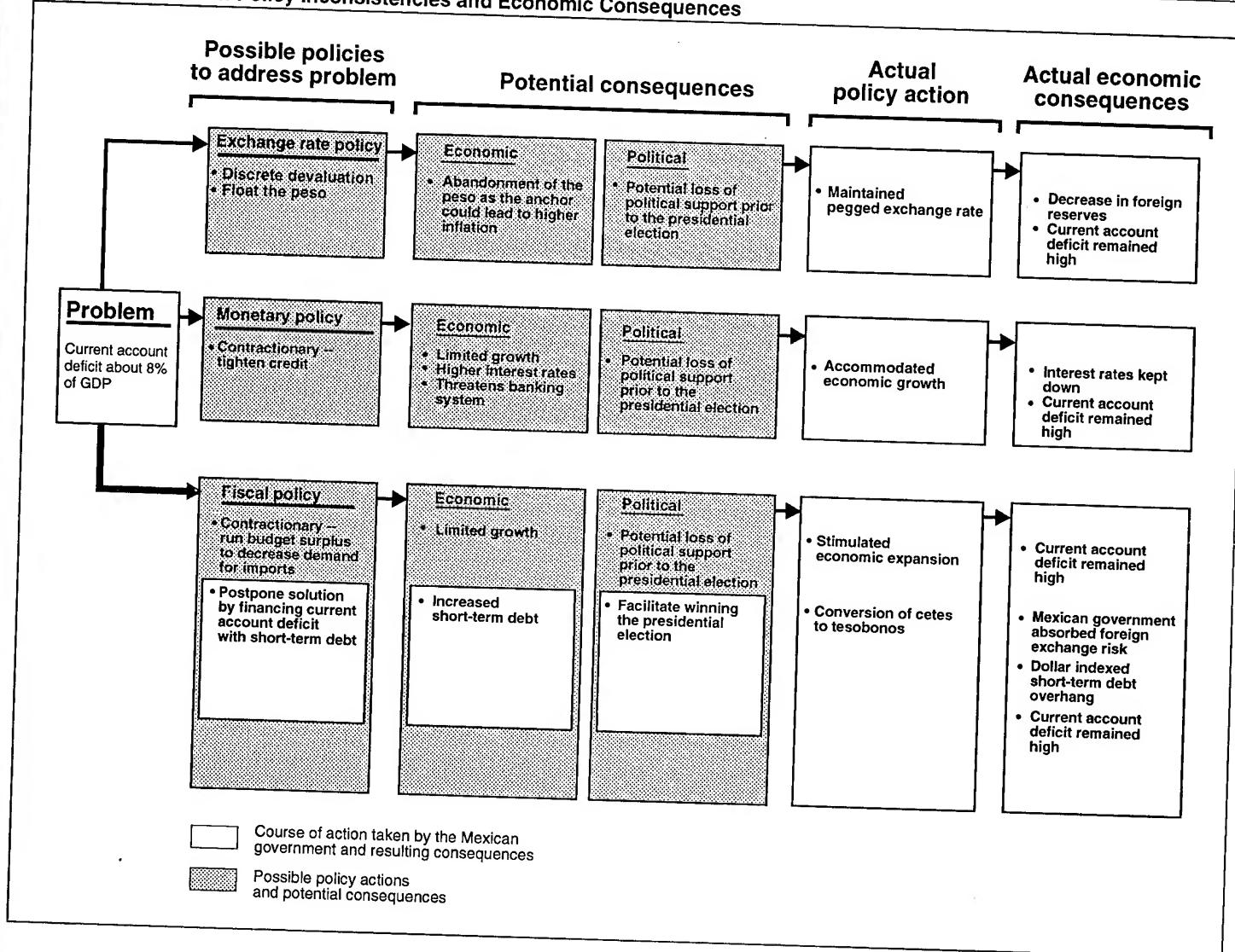
The government of Mexico did not address the fundamental weakness in the Mexican economy, namely the growing current account deficit, by the measures adopted following Colosio's assassination. During the period leading up to the August presidential elections, Mexican financial authorities attempted to maintain economic growth momentum, putting further pressure on the current account deficit. Gradually, inconsistencies emerged among monetary, fiscal, and exchange rate policies.

Government Strove to Promote Economic Growth Before Elections

By the middle of 1994, the Mexican economy was entering an expansionary phase, partly as a result of government development banks providing credits that stimulated economic growth. It was also evident that Mexico's current account deficit would be higher than that in 1993 unless the government took steps to reduce consumption. However, according to Mexican officials, with Zedillo trailing in the polls only 3 months before the presidential election, the government was reluctant to take any measure that could derail economic growth. Moreover, Bank of Mexico and Finance ministry officials told us that they were confident that a successful conclusion to the elections would restore capital inflows to Mexico and allow financing of the current account deficit.

In the period leading up to the presidential elections, Mexican financial authorities adopted exchange rate, fiscal, and monetary policies that either supported or accommodated economic growth. In terms of the exchange rate, no further action was taken to correct for the real appreciation of the currency. Fiscal policy, meanwhile, became somewhat expansionary as government financial intermediaries—government development banks and trust funds—pumped credit into the economy. Monetary policy accommodated the economic expansion by keeping interest rates low. Although interest rates did rise somewhat, the rise was not enough for the Bank of Mexico to be able to defend the peso. These policies became increasingly inconsistent with each other, adding to an increase in the current account deficit and postponing action on the overvalued currency. (See fig. 2.11.)

Figure 2.11: Mexican Policy Inconsistencies and Economic Consequences



Source: GAO analysis.

No Adjustments Made in Exchange Rate Policy

According to various economic analysts, in 1994 Mexican authorities could have attempted to reduce the current account deficit by adjusting the country's exchange rate. As previously noted, the article by Dornbusch and Werner¹² argued in favor of this course of action. They said that despite some productivity growth, Mexico was experiencing a loss in

¹²“Mexico: Stabilization, Reform, and No Growth.”

competitiveness due to the overvaluation of the currency. However, Mexican officials explained that in the months leading up to the national elections, the government was not prepared to do anything that might upset the consensus reached with business and labor within the context of the Pacto. Moreover, Bank of Mexico and Finance ministry officials told us they believed that because of the outstanding performance of Mexican exports in 1994, arguments by financial analysts that the peso was overvalued were exaggerated. Consequently, until the end of 1994, the only action on the exchange rate policy acceptable to Mexican authorities was allowing the peso to depreciate against the dollar to the maximum extent allowable within the established exchange rate band.

Fiscal Policy Stimulated Economic Expansion

Other economic analysts have argued that Mexican authorities could also have pursued tighter fiscal policies to reduce the current account deficit in 1994. The government could have reduced expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso. In effect, the government could have compensated for the decline in private domestic savings with a corresponding increase in public domestic savings. This could have been achieved by raising taxes, or by reducing government expenditures, or by undertaking a combination of both these measures. The Mexican government, however, had already undergone several years of difficult budget cutting, taking the federal budget from a deficit equal to 9.3 percent of GDP in 1988 to a surplus of 0.7 percent of GDP in 1993, according to Bank of Mexico data. Moreover, Mexico's total net public sector debt had been reduced from nearly 50 percent of GDP in 1988 to about 25 percent of GDP by 1993. Given this diminishing level of public indebtedness, Mexican authorities argued that it would have been difficult to pursue a fiscal surplus and accept high levels of unemployment and slow economic growth. They further argued that such actions would have had an immediate adverse impact on economic growth, and this policy change would have been particularly difficult to achieve in a national election year.

Instead of pursuing a policy of fiscal restraint, the Mexican government actually increased spending in 1994. Figures on public sector expenditures for 1994 indicate government spending stimulated economic growth, particularly in the construction and energy sectors. Overall budgeted federal expenditures grew by 11.6 percent. According to the Bank of Mexico, the nonfinancial public sector economic balance ended in a deficit of 1.1 percent of GDP. The government also provided considerable credits through financial intermediaries, such as development banks and trust

funds. If this financial intermediation by government institutions is taken into account, Mexico's budget deficit for 1994 reached 4.7 percent of GDP.

Monetary Policy Accommodated Economic Growth

In order to reduce the current account deficit in 1994, Mexican authorities could have pursued a more stringent monetary policy, as a number of economic analysts have noted. In discussions with us and in various publications,¹³ Bank of Mexico authorities have asserted that throughout 1994 they pursued a monetary policy that was not expansionary. As evidence that the monetary policy pursued in 1994 was not expansionary, these officials pointed to (1) the modest growth in the monetary base when compared to the growth of Mexico's nominal GDP over the course of the year, (2) the relatively low level of inflation despite economic growth, (3) the high interest rates that prevailed during much of the year, and (4) the stability of foreign reserves from April to November. In addition, a Bank of Mexico official noted that monetary policy was geared toward supporting the exchange rate regime, which was consistent with achieving price stability. This official stated that in 1994 inflation was only 7.1 percent, the lowest in 22 years. In retrospect, however, several economists have argued persuasively that developments in 1994 suggest that Mexican monetary policy accommodated economic expansion, and that it was not entirely consistent with the government's exchange rate policy.¹⁴

As Mexico began losing reserves following the Colosio assassination, the Bank of Mexico compensated for the effects on the domestic monetary base of decreases in foreign reserves by increasing domestic credit.¹⁵ This strategy offset the contractionary impact on the monetary base caused by the loss of foreign reserves and kept interest rates from rising to levels that otherwise might have caused severe economic disruption. According to Bank of Mexico officials, the newly privatized and weak Mexican banking system would have been imperiled by such high interest rates. In any event, some economists noted that by providing credit to the economy

¹³See Banco de Mexico, Informe Anual 1994, Banco de Mexico, Mexico City: April 1995; and Banco de Mexico, The Mexican Economy 1995: Economic and Financial Developments in 1994 and Policies for 1995, Banco de Mexico, Mexico City: June 1995.

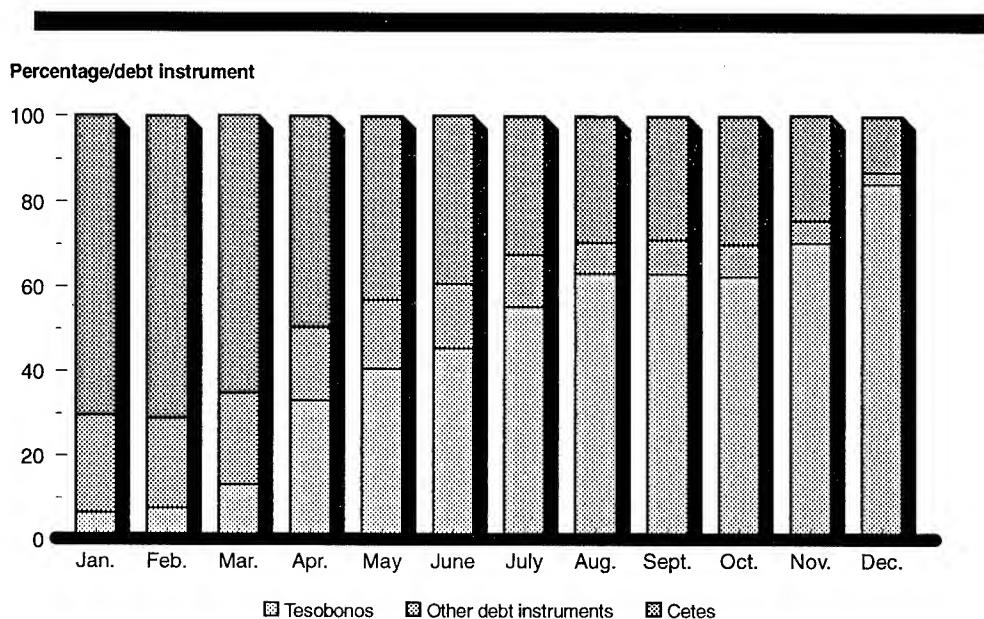
¹⁴See Nora Lustig, "The Mexican Peso Crisis: The Foreseeable and the Surprise," Brookings Discussion Papers in International Economics (Washington, D.C.: The Brookings Institution, June 1995).

¹⁵The strategy of compensating for losses or gains in foreign reserves by respectively increasing or decreasing credit available to the domestic economy is known as "sterilization." Until February 1994, the Bank of Mexico had sterilized capital inflows by reducing domestic credit. This was done to combat inflation and relieve pressure on the current account deficit. When capital started flowing out, authorities applied this policy in reverse.

in order to compensate for the loss of foreign reserves, the Bank of Mexico forestalled a contraction in the monetary base and a rise in interest rates that would have led to an economic downturn. These economists explained that even though pursuing tighter monetary policy would have had a contractionary impact on the economy in the short run, it would also have led to a reduction of the current account deficit in the long run.

As noted earlier, Mexican authorities did succeed in stabilizing the level of foreign reserves by the end of April, and reserves remained stable until mid-November 1994. This was not achieved primarily because of strict monetary policy, which would have entailed offering interest rates high enough to attract and maintain foreign investors. Investors were demanding higher interest rates on newly issued cetes because of their perception that the peso would eventually be subject to a relatively large devaluation. After the Colosio assassination, interest rates did rise significantly from about 9 percent to about 20 percent. But by the end of April, rates declined somewhat and remained between 15 and 20 percent until the December crisis. Even at these interest rate levels, demand for cetes lagged. Instead of raising interest rates further, the government managed to attract investors by shifting from peso- to dollar-indexed securities to finance its internal debt. As illustrated in figures from the Bank of Mexico, from January to November, foreign investment in tesobonos rose from 6.4 percent to 70.2 percent of total foreign investment in Mexican government securities. Conversely, foreign investment in cetes declined from 70.3 percent to 24.4 percent of foreign investment in Mexican securities. By shifting from cetes to tesobonos and assuming the foreign exchange risk for its own securities, the Mexican government avoided paying the higher interest rates investors were demanding for holding peso assets. The shift from cetes to tesobonos forestalled the contractionary impact that even higher interest rates would have had on the economy. It also did nothing to reduce the current account deficit. Moreover, as sales of tesobonos rose, Mexico became vulnerable to a financial market crisis because many tesobono purchasers were portfolio investors who were very sensitive to changes in interest rates and risks. Tesobonos had short maturities, which meant their holders might not roll them over if investors perceived (1) an increased risk of a Mexican government default or (2) higher returns elsewhere. (See fig. 2.12.)

Figure 2.12: Foreign Investment in Mexican Government Securities, 1994



Note: Other debt instruments include ajustabonos (peso-denominated Mexican treasury bonds that are adjusted for Mexican inflation) and bondes (peso-denominated Mexican development bonds).

Source: Bank of Mexico.

Mexican officials said that they were aware of the risks involved in switching from cetes to tesobonos to finance the current account deficit. By issuing increasing amounts of tesobonos, the government of Mexico was in effect reducing its ability to maneuver within the exchange rate policy. Mexican authorities explained that they pursued this strategy for several reasons. First, Bank of Mexico and Finance ministry officials were confident that the peso was not overvalued. They maintained that the boom in Mexican exports and gains in productivity were not consistent with an overvalued currency. Second, the strategy had been tried before and had proven successful. Mexican officials told us that foreign investment in Mexico had dipped in late October and November 1993 due to the debate over the vote in the U.S. Congress on legislation to implement NAFTA. At that time, Mexican authorities had issued more tesobonos to attract foreign investors. After the success of the NAFTA vote,

investors switched back to cetes, which carried a higher interest rate (see fig. 2.6). Mexican authorities said they expected that following the successful conclusion of the presidential election in August 1994, tesobono holders would once again switch back to cetes. In addition, Bank of Mexico officials said that they opposed allowing too dramatic a hike in cetes interest rates because this might have sent the wrong message to financial markets. They noted that investors were concerned about the effect higher interest rates would have on the Mexican banking system and their impact on debtors and financial intermediaries.

Renewed Political and Financial Instability Precipitated Floating of Currency

Expected high levels of investment flows failed to materialize following the elections in August 1994. Just when stability appeared to have been restored after the successful outcome of the presidential election, Mexico was rocked by a new series of political shocks. Moreover, in the process of the transition to a new government, the newly appointed team that assumed responsibility for Mexico's financial affairs committed a series of key errors, according to Mexican government officials and financial analysts we interviewed. These errors precipitated further losses in foreign exchange reserves and eventually provoked a crisis when the decision was finally made to devalue the peso. (See fig. 2.13.)

Figure 2.13: Selected Political and Economic Events, July 1994 - September 1994

	Political events	Economic events
July '94		<p>29 Mexico's end-of-month foreign currency reserves are \$16.2 billion.</p>
August '94	<p>21 Presidential elections are held.</p> <p>29 Zedillo is officially announced as President-Elect.</p>	<p>16 U.S. Federal Reserve increases interest rates from 4.25% to 4.75%.</p> <p>31 Mexico's end-of-month foreign currency reserves are \$16.4 billion.</p>
September '94	<p>28 Mexican PRI Secretary General Jose Francisco Ruiz Massieu is assassinated.</p>	<p>30 Mexico's foreign currency reserves decline slightly to \$16.1 billion.</p>

Source: GAO analysis.

Post-Election Surge in Investment Flows Failed to Materialize

Mexican financial authorities told us that they expected a turnaround in investment flows following the election. They stated that they believed the successful results of the presidential election in August would reassure investors. Moreover, Mexico's economic indicators showed positive economic performance for 1994. The economy was growing, inflation was at the lowest level in over 2 decades, exports were booming, and

productivity was up. Nevertheless, foreign investment flows did not return to Mexico as anticipated. Some economists have suggested that investors at this point may still have been reacting to rising U.S. interest rates. On the other hand, Mexican interest rates had actually declined after the surge in April and did not increase after the August election. Interest rates and other external factors made Mexico less attractive for portfolio investors, according to market analysts. For example, according to IMF data, real interest rates offered for Mexican Treasury bills in September through November were only about 4 to 5 percentage points higher than rates on U.S. Treasury bills.

The Bolsa is an indicator of investors' interest in the Mexican economy. Although the stock market had lost substantial value during the spring, it began a period of recovery during the summer of 1994 as the political situation stabilized. The Bolsa index rose to about 2,700 in August as it became apparent that the election was not going to result in political instability; then it climbed to 2,746 by the end of September. However, the market weakened in the fall, as some companies reported disappointing results for the third quarter due to high financing costs when foreign capital flows dried up. The Bolsa closed at the end of November at 2,591 (see fig. 2.8).

Further Losses in Reserves Provoked by Political Instability

Although the high level of investment flows failed to materialize as expected, the August election appeared to signal a return of political stability. Zedillo had won the presidential election with a comfortable margin, and the election, which had been monitored by international observers, was declared essentially fair and clean.¹⁶ However, on September 28, 1994, Jose Francisco Ruiz Massieu, secretary general of the PRI, was murdered outside a hotel in Mexico City. This second high-level political assassination, only 6 months after the murder of Colosio, sent a new shock wave through the Mexican political system.

Attention was once more drawn to unanswered questions about the investigation into the Colosio assassination, with speculation in the press about possible internal struggles and conspiracies within PRI that had turned violent. The difficult political situation was only exacerbated in mid-November, when Deputy Attorney General Mario Ruiz Massieu, who was heading the investigation of his brother's assassination, accused PRI officials and the Mexican Attorney General of obstructing the investigation

¹⁶Zedillo of PRI won the election with 50 percent of the valid votes. Cevallos of the National Action Party (PAN) got 27 percent of the votes, and Cardenas of the Party of the Democratic Revolution (PRD) received 17 percent of the votes.

into his brother's assassination. Eventually, Ruiz Massieu resigned from his post and from PRI. (See fig. 2.14.)

Figure 2.14: Selected Political and Economic Events, October 1994 - December 1994

	Political events	Economic events
October '94	<p>24 Pacto is renewed by Salinas.</p>	<p>19 Bank of Mexico announces international reserves are \$17.2 billion as of October 14.</p> <p>31 Mexico's end-of-month foreign currency reserves are \$17.2 billion.</p>
November '94	<p>20 President-Elect Zedillo reaffirms the Pacto agreement.</p> <p>23 Deputy Attorney General Mario Ruiz Massieu resigns from government and PRI, alleging a cover-up in his brother's assassination.</p>	<p>1 President Salinas announces international reserves of \$17.2 billion.</p> <p>15 U.S. Federal Reserve increases interest rates from 4.75% to 5.50%.</p> <p>30 Mexico's end-of-month foreign currency reserves fall sharply to \$12.5 billion.</p>
December '94	<p>1 Inauguration of Ernesto Zedillo as president of Mexico.</p> <p>19 EZLN rebels renew violence in Chiapas.</p>	<p>9 Finance Minister Serra Puche presents budget to the Mexican Congress.</p> <p>20 Peso is devalued by 15%.</p> <p>21 Mexico loses \$4 billion in foreign currency reserves defending the peso.</p> <p>22 Peso is allowed to float. Mexico activates swap line with United States and Canada.</p> <p>31 Mexico's end-of-month foreign currency reserves fall to \$6.2 billion.</p>

Source: GAO Analysis.

In the midst of the unfolding political scandal over the Ruiz Massieu investigation, renewed hostilities erupted in the state of Chiapas. The

cease-fire that had endured in that state since January was broken in early December. Violence resumed again as two contenders for the post of state governor claimed to have won the election.

Mexican Nationals Reacted to Deteriorating Situation Before Foreign Investors Did

A difference in perspective between domestic and foreign investors regarding financial and political developments may explain the loss of foreign reserves Mexico began to experience in mid-November. IMF research indicates that pressure on foreign reserves during this period came from Mexican residents rather than from the flight of foreign investors or from speculative position taking. A Mexican government official expressed serious reservations about the methodology used by IMF to come to this conclusion. However, some U.S. market analysts also complained that Mexico's infrequent release of financial data in 1994, particularly the release of foreign reserves levels only three times a year, contributed to their misjudgment of Mexico's financial condition. At the same time, a Bank of Mexico official told us that experienced analysts could have calculated the level of foreign reserves by using other Bank of Mexico data. Some economic analysts suggested that Mexican investors, who were more sensitive to the deteriorating political situation and had experience with the pattern of peso devaluation at the end of previous presidential terms, reacted to events more rapidly than did foreign investors by trading pesos for dollars during the final months of 1994. Nevertheless, a Mexican government official disagreed with these analysts, suggesting that Mexicans were not better informed than foreign investors were about the financial situation at the time.

Other Factors Shaped Internal Mexican Government Debate on Exchange Rate

The political scandal unleashed by the allegations of Ruiz Massieu renewed apprehension among investors regarding Mexico's political stability and triggered a new round of capital flight. Foreign reserves, which on average had remained stable at approximately \$16 billion to \$17 billion from late April to mid-November, dropped to less than \$13 billion by November 18. Capital flight led to renewed pressure on the exchange rate. Toward the end of November, key financial decisionmakers from the Bank of Mexico, the outgoing Salinas administration, and the administration of President-Elect Zedillo, met to determine what strategy to pursue on exchange rate policy. At this time, Mexican financial authorities decided against devaluing the currency.

According to a published account of events by the former Mexican Finance Minister, allowing an abrupt fall in the value of the peso against

the dollar, beyond the limits set by the established exchange rate band, would have led to a loss of credibility and confidence. At various times during 1994, the Mexican Finance ministry had assured investors that there would not be a devaluation of the currency outside the exchange rate band. Instead of devaluing the currency, Mexican authorities agreed to seek to calm financial markets by ratifying the government's commitment to exchange rate stability within the context of renewing the Pacto.

**1995 Budget Presentation
to Mexican Congress
Lacked Credibility**

Reaffirming the new administration's commitment to the exchange rate band on November 20, as part of a reaffirmation of the Pacto, temporarily halted the drain in foreign reserves. From that date through the first 2 weeks of December, foreign reserves remained above the \$12-billion level. However, on December 9, the new administration presented its 1995 budget to the Mexican Congress. According to Mexican economists and government officials, this budget was based on unsustainable economic projections; most notably, it anticipated a significant increase in the current account deficit in 1995.

Mexican economists and government officials told us that the 1995 budget projections caused a great deal of concern in financial markets. It appeared that the new administration was still unwilling to address the inconsistencies in Mexican fiscal, monetary, and exchange rate policies. Mexico would not be able to finance a current account deficit greater than the one in 1994 as well as defend the existing exchange rate with the levels of reserves available in early December 1994. A growth in the current account deficit was only possible if Mexico could attract sufficiently high levels of new capital from abroad. But Mexico was not attracting capital; instead, capital was leaving Mexico.

**Peso Devaluation
Mishandled**

Capital flight resumed after the budget presentation, and by the following week, foreign reserves had dropped below \$10.5 billion. According to Mexican officials, at this time it was clear that the existing exchange rate could not be maintained, given the dwindling level of reserves. On December 19, government officials called a meeting of the parties to the Pacto and proposed allowing the peso to float. However, according to several Mexican officials, the business community refused to accept the concept of a floating exchange rate. Business leaders argued that simply allowing the peso to float would send the wrong signal to financial markets. Since the market had overshot on previous devaluations,

business leaders wanted to fix the exchange rate at a reasonable level. The government yielded to business concerns and agreed to announce a 15-percent depreciation of the existing exchange rate band, rather than allow the peso to float.

According to former Finance ministry officials and representatives of several major investment organizations, the December 19 devaluation was mishandled and provoked a financial crisis that was unwarranted. The decision to announce a 15-percent depreciation of the currency on December 19 made matters much worse for Mexico. December 19 was also marked by fighting in the Mexican state of Chiapas, which renewed apprehension among investors regarding Mexico's political stability. During the 2 days that followed, the Bank of Mexico lost nearly half of the remaining foreign exchange reserves while trying to defend the new peso/dollar exchange rate. According to Bank of Mexico officials, allowing the peso to float from the start might have avoided this loss of foreign reserves.

According to Mexican government officials and academic experts, the new Mexican administration was also unprepared to handle ensuing developments. It is traditional in Mexico that a change in presidents is accompanied by a change in the staff in most ministries. Consequently, relatively few officials from the prior administration were left in the Finance ministry to respond to inquiries from investors regarding the sudden decision to change the exchange rate policy. One former Finance ministry official noted that instead of explaining the situation openly to investors, the government tried to portray its decision as a minor adjustment in the exchange rate band, rather than as a devaluation. But after repeated assurances that there would not be a devaluation, this stance on the part of the government only undermined investor confidence even further.

After markets closed on December 21, Mexican authorities announced that they would no longer try to defend the peso/dollar exchange rate, effectively abandoning the exchange rate band and allowing the peso to float. Economic analysts we spoke to in the United States and Mexico agreed that the government made a critical mistake at this point by failing to put in place an economic adjustment plan to accompany the decision to float the peso. These analysts argued that at this point the Mexican government needed to reassure financial markets that it was prepared to take tough measures to stabilize the economy and address the adverse economic consequences inherent in a major devaluation. They said that

the government needed to make public a plan that would have included fiscal restraint, a restrictive monetary policy, and negotiation of a line of credit from IMF. But no such measures were taken or announced for several weeks following the decision to float the peso. According to several U.S. government officials and Wall Street investment analysts, during this time the initial anxiety over the value of the peso turned into a general sense among investors that Mexico might be forced to default.

Devaluation Degenerated Into Financial Crisis by January 1995

Delays in Decisive Action Exacerbated Financial Crisis

After the peso was allowed to float, market analysts believed that the government of Mexico needed to take steps to restore investor confidence and regain financial stability. This was especially important because, as the Mexican Finance Minister has stated, the mechanics of the devaluation were badly timed and badly executed. Events after the devaluation did not lead international financial markets to conclude that Mexico was stable, however. To the contrary, according to U.S. officials and Wall Street market analysts, investors became increasingly skeptical about Mexico's financial future in light of the Mexican government's response to the crisis. For example, one analyst told us that the Mexican government appeared unwilling to allow interest rates to rise to market levels and, as a result, many investors sold their securities.

A significant influence on investors was information emerging on Mexico's remaining reserves and, most significantly, its short-term debt. In January 1995, Mexico faced the need to pay out about \$10 billion for tesobonos coming due in the following 3 months unless it could convince bondholders to buy new Mexican government debt securities. As investors became aware that Mexico had only about \$6 billion in foreign reserves in early January 1995, they were increasingly concerned about the possibility of default and sought to redeem their investments.

A senior Finance ministry official explained that during the crisis, Mexico could not reissue its internal debt at any price. Bondholders were numerous, unlike the situation when a few large banks held a much larger

proportion of Mexican external debt in 1982.¹⁷ The market was more volatile in January and February of 1995. This official added that perception became reality when investors feared they could not get their money back.

Key Mexican financial indicators revealed that investors were leaving Mexican markets after the devaluation of the peso. For example, the Bolsa index declined sharply in the wake of the devaluation. From December 20, 1994, to February 27, 1995, the Bolsa index fell 36.3 percent in nominal peso terms. The index began in 1995 at 2,376, and then dropped by the end of January to 2,094. As Mexico's financial situation continued to deteriorate, the market index fell throughout February, reaching a low of 1,448 on February 27 (see fig. 2.8). According to IMF, overall net capital outflows totaled more than \$11.5 billion in the first quarter of 1995.

The Governments of Mexico and the United States Took Remedial Action

During the period from December 22, 1994, to January 12, 1995, a variety of actions were taken to deal with Mexico's financial problems. On December 28, Finance Minister Jaime Serra was replaced by Guillermo Ortiz, previously Secretary of Communications and Transport. On December 30, 1994, Mexico's swap line was increased. A short-term Bank for International Settlements (BIS) facility was arranged for the Bank of Mexico. An announcement was made of an effort to raise funds from a group of international commercial banks. Mexico announced that it would seek an IMF stand-by arrangement, and efforts were made to line up loans and disbursements from multilateral development banks.

On January 2, 1995, President Zedillo announced an emergency economic plan that was designed to reassure the international investment community that Mexico had its economic affairs back in order. The plan aimed to avoid an inflationary spiral, reestablish investor confidence, and stimulate structural reforms to enhance economic growth. On the domestic front, the plan laid out a strict policy on wage increases of only 7 percent, cuts in public spending equal to 1.3 percent of GDP, a reduction of development bank lending by 2 percent of GDP, and some expansion of privatization. The current account deficit for 1995 was projected to be \$14 billion or 4.2 percent of GDP. This Pacto was supported by an exchange stabilization fund of \$18 billion in short-term credit lines provided by

¹⁷In 1982, Mexico's external debt was concentrated in the hands of a small number of large foreign banks. Concerned about their significant exposure, these banks had a stake in restructuring Mexico's external debt. However, in 1995 Mexican internal debt was dispersed among numerous private investors and investment funds that had invested in Mexican securities. Mexican authorities had little leverage over these investors.

foreign governments, led by Treasury and Federal Reserve in the United States, in cooperation with the Bank of Canada, and other central banks acting through BIS and in cooperation with a small group of international banks. The omission of wider reforms and doubts about its wage pact led to an unfavorable reaction from financial markets.

Also on January 2, 1995, Treasury and the Federal Reserve announced supplemental swap facilities for Mexico. The existing \$6 billion swap agreement between the United States and Mexico was supplemented with an additional \$3 billion short-term facility, with Treasury and the Federal Reserve each participating up to \$1.5 billion. That is, the U.S. swap line with Mexico was increased to \$9 billion. A Treasury official stated that the decision to increase the swap line with Mexico was based on the importance of the U.S.-Mexican economic relationship, the substantial economic reforms that Mexico has undertaken in recent years, and the strong program just announced by President Zedillo. Also, the existing Canadian \$1 billion swap facility between the Bank of Canada and the Bank of Mexico was supplemented by an additional Canadian \$500 million. The action was taken in the context of the North American Financial Group.

On January 9, 1995, the Bank of Mexico announced a new policy on regular announcements of its foreign exchange reserves. Also, on January 9, the Bank of Mexico announced drawings on the North American Financial Agreement swap facilities including \$500 million from U.S. monetary authorities and Canadian \$83 million from the Bank of Canada. In addition, the Bank of Mexico announced plans to use \$16 billion of credit to help the nation's banks and companies with dollar-denominated liabilities.

On January 9, both U.S. and Mexican monetary authorities intervened in foreign exchange markets to stabilize the value of the peso. The Federal Reserve Bank of New York announced that, consistent with the efforts of U.S. monetary authorities to assist Mexico in responding to recent financial developments, it was intervening in the foreign exchange market at the request of, and for the account of, the Bank of Mexico, purchasing pesos in exchange for dollars. Mexico also intervened in the New York and Mexican foreign exchange markets for the first time since the floating of the peso on December 22.

U.S. Government and IMF Awareness of Mexico's Financial Situation, and Advice Provided to Mexican Government

Our document review and interviews with Treasury, State Department, and Federal Reserve officials showed that senior U.S. officials were kept apprised of economic and political developments in Mexico during 1994. They exchanged views with Mexican officials on multiple occasions on the appropriateness of Mexico's exchange rate policy. Before the Colosio assassination in March, officials at Treasury and State Departments and at the Federal Reserve had some concerns that Mexico was vulnerable to speculative attacks on the peso and that Mexico's large current account deficit and its exchange rate policy might not be sustainable. One month after the Colosio assassination, the United States and Canada established permanent, enlarged currency swap facilities that could be used to help Mexico defend the peso from any future speculative attacks. Financial markets' reaction to the Colosio assassination, documents showed, also increased Treasury, State, and Federal Reserve officials' concerns about the viability of Mexico's exchange rate policy.

Our review showed that by early summer 1994, staff in the Federal Reserve had concluded that the peso probably was overvalued. But they remained unsure about whether and, if so, when and in what manner, financial markets would force Mexico to react. Federal Reserve, Treasury, and State Department documents from this period showed that their analysts generally believed that Mexican financial markets would remain volatile until the Mexican presidential election in August, but that after the election, foreign investment inflows to Mexico might recommence and pressure on the peso might abate. In July 1994, U.S. and Mexican officials reached an oral understanding that Mexico would devalue the peso after the election if continued pressure on the peso led to a further drawdown of Mexico's foreign currency reserves.

After the election, when foreign investment flows to Mexico did not resume in significant amounts and Mexico's foreign currency reserve levels remained at pre-election levels, concern grew within the Treasury and State Departments and the Federal Reserve over the extent of the peso's overvaluation and the sustainability of Mexico's exchange rate policy. Treasury and Federal Reserve officials told us that they were concerned about whether Mexico's exchange rate policy was consistent with other Mexican macroeconomic policies. During October and November, high-level U.S. officials cautioned Mexican officials that the peso seemed overvalued and indicated that it was risky to continue the existing exchange rate policy. Treasury Department and Federal Reserve analyses provided to us for the late August through December 20 period

did not foresee nor judge likely that a forced devaluation would require a major financial assistance package from the United States.

There were several reasons why senior Treasury, State, and Federal Reserve officials did not provide stronger advice to Mexican authorities during 1994. First, the evidence and analyses that the peso needed to be devalued were not sufficiently compelling for them to provide more adamant advice to devalue. Also, as they testified, U.S. officials (1) were sensitive to the fact that decisions on whether and how to change Mexican economic policies ultimately rested with Mexico; (2) had confidence in the competence of Mexican economic management; and (3) believed that if Mexico were forced by financial markets to devalue the peso, the consequences would not be as severe for Mexico and for other developing countries' financial markets as they turned out to be. U.S. officials did not publicly discuss their concerns over Mexico's financial situation in 1994 out of concern about provoking an immediate flight of capital from Mexico.

The International Monetary Fund (IMF) completed an annual review of Mexico's foreign exchange policy and economic policies in February 1994. The review did not identify problems with Mexico's exchange rate policy. Further, Treasury and IMF officials told us that IMF did not keep close watch on developments in Mexico during 1994, did not foresee the crisis, and did not see a compelling case for Mexico to alter its exchange rate policy before the December 20, 1994, devaluation.

U.S. Officials Monitored Mexican Situation Throughout 1994

The documents we reviewed showed that throughout 1994, officials in several federal agencies monitored economic and political developments in Mexico, and senior officials were kept informed about developments thought to be important. The Treasury Department's financial attache at the U.S. embassy in Mexico City provided biweekly reports on financial developments in Mexico, as well as other information on Mexico's economic situation, to Treasury officials in Washington, D.C. These officials evaluated developments in Mexico, using the information supplied by the financial attache and other sources, and reported to the Under Secretary of the Treasury for International Affairs.

Officials in the Federal Reserve also monitored the Mexican situation. Analysts at the Federal Reserve Bank of New York and at the Federal Reserve Board in Washington, D.C., tracked events in Mexican financial markets and informed members of the Federal Reserve's Federal Open

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Market Committee (FOMC)¹ of important developments. The State Department followed events in Mexico from the U.S. embassy and consulates in Mexico, and from Washington, D.C. U.S. embassy staff in Mexico City provided, among other information and analyses, weekly reports on financial developments in Mexico to State Department headquarters. CIA also monitored events in Mexico.

U.S. and Mexican authorities maintained contact throughout 1994. These contacts provided opportunities for U.S. and Mexican officials to exchange views on Mexico's economic situation and policies, both formally and informally. For example, U.S. and Mexican officials met at the annual meeting of the U.S.-Mexican Binational Commission in May 1994 and at the annual meeting of the World Bank and IMF in Madrid, Spain, in October 1994. Also, the U.S. Treasury Secretary and other high-level U.S. officials visited Mexico on several occasions in 1994. Further, senior Mexican officials travelled to the United States to meet with senior administration officials, including the Secretary of the Treasury and the Chairman of the Federal Reserve. Also, beginning in June 1994, Federal Reserve, Mexican, and Canadian central bank officials held regular telephone discussions on developments in financial markets in connection with the establishment of the North American Financial Group.

For the following discussion of the events of 1994, we divided the year into 2 periods based on significant events. The first period—January 1 to July 31—included the assassination of Colosio in March, Mexico's reaction to falling investor confidence after the assassination, and preparation for the August presidential election. The second period—August 1 through December 22—included the election on August 21, the growing overvaluation of the peso through the fall, and the devaluation of the peso on December 20.

¹FOMC sets monetary policy for the Federal Reserve. The Committee comprises the seven Federal Reserve governors and the presidents of Federal Reserve banks, with five of the presidents serving as voting members at one time.

January Through July 1994: U.S. Officials' Concerns Over Mexico's Economic Situation Grew as Events Unfolded

January 1, 1994, Through
March 23, 1994: U.S.
Officials Somewhat
Concerned About Mexican
Macroeconomic Policies

Our review of Treasury and State Department and Federal Reserve documents and interviews with their officials indicated that before the March 23, 1994, assassination of PRI presidential candidate Colosio, U.S. authorities had some concerns over the sustainability of Mexico's macroeconomic and exchange rate policies during the short run. Documents and interviews with U.S. officials showed that they were aware that Mexico was experiencing a large current account deficit financed mostly by short-term portfolio capital that was vulnerable to a sudden reversal of investor confidence in Mexico. U.S. officials also were concerned that declining Mexican interest rates, coupled with rising U.S. interest rates and investment opportunities in other emerging markets, could lead to capital outflows from Mexico and pressure on the peso. In addition, one Treasury memorandum expressed concern that Mexico's inflation rate had remained above that of the United States for several years and that this had caused the peso to appreciate in relation to the dollar in inflation-adjusted terms. A senior Treasury official advised us that Treasury believed Mexico's economy was fundamentally sound in the sense that Mexico had implemented many macroeconomic reforms such as balancing its fiscal account and carrying out structural reforms that made its economy more competitive. However, he said, even in February 1994 he felt that Mexico's exchange rate was "on the high side" because of Mexico's inflation differential, relative to the United States, and its large trade deficit. A Federal Reserve official told us that the Federal Reserve had become concerned about the size of Mexico's current account deficit and its exchange rate policy even before 1994.

However, it appears that these concerns were outweighed by a number of other considerations that pointed to a more optimistic view of Mexico's near-term economic prospects. Perhaps foremost was that these U.S. government officials believed that Mexico had sound economic fundamentals and appeared to have laid an adequate foundation for

economic growth in the long term, due in large part to the major economic reforms that Mexico had implemented in the previous decade. Further, in the period between the approval of NAFTA and the Colosio assassination, Mexico was continuing to attract large amounts of foreign capital, and the Bank of Mexico held substantial foreign currency reserves. Also, the peso was trading in the strongest region of its trading band. A February 10, 1994, Treasury memorandum informed the Secretary of the Treasury that the peso could lose 8 percent of its value and still remain within the band.

Still, documents showed that U.S. officials recognized that adverse political events could again shake investor confidence in Mexico. For example, a March 21, 1994, Federal Reserve staff paper noted that political events, such as the Chiapas uprising in January 1994 and uncertainty over the outcome of the August 1994 Mexican presidential election, had "unnerved" Mexican foreign exchange and cetes markets. And, the paper said that underlying economic conditions—not just political events—were consistent with a weakened peso. However, the paper listed several factors that it said might "obviate the need for a peso depreciation in the near-term." These factors, according to the paper, included Mexico's substantial foreign currency reserve levels, the Mexican government's pledge to maintain a stable peso exchange rate, and the likelihood that foreign capital inflows would continue at high levels in 1994.

U.S. officials, although somewhat concerned at this time that the peso was vulnerable, appear to have believed that Mexican authorities could manage any future such crises. An event in 1993 had lent credence to this view. In November 1993, foreign portfolio flows into Mexico had reversed suddenly due to uncertainty about whether the U.S. Congress would approve NAFTA. Intense speculative pressure on the Mexican peso led to a sudden drawdown of Mexico's foreign currency reserves. According to a State Department document, the Mexican government responded to the pressure by allowing the peso to depreciate and, as chapter 1 discussed, by issuing more tesobonos. The U.S. and other governments reacted by arranging a temporary short-term, \$12-billion swap facility for Mexico through the Bank for International Settlements (BIS). This facility was never used. After Congress approved NAFTA, foreign investment flows quickly resumed, and the peso appreciated and then stabilized. Several Treasury and State Department documents from January and February 1994 cited these events in discussions of Mexico's financial situation.

Further, in December 1993, the Secretary of the Treasury had agreed to consider a Mexican request to enlarge substantially, from \$1 billion to about \$5 billion, a permanent currency swap facility that Mexico maintained with the United States.² According to a Federal Reserve official, the enlarged swap facility would allow Mexico to maintain orderly exchange rate markets, even during times of intense speculative pressure on the peso caused by financial markets' reactions to political events. U.S. officials had explained to Mexican officials that the facility was to be used to respond to disorderly market conditions and that the United States would not allow an expanded swap facility to be used to support an overvalued peso.

Because U.S. government officials did not perceive a high risk of financial difficulty in Mexico in the near term, they were not adamant in voicing their concerns over Mexico's immediate economic prospects and policies to Mexican authorities before the Colosio assassination. During Mexico's annual consultation with IMF in February 1994, the U.S. government raised some questions about the size of Mexico's current account deficit and the lack of GDP growth in Mexico. Yet the U.S. administration did not dispute the thrust of the IMF's staff report, which was supportive of Mexico's ability to manage the situation.

Also in February 1994, the U.S. Treasury Secretary and other senior Treasury officials visited Mexico City. The Treasury Secretary met with Mexico's President, Finance Minister, and other senior Mexican officials. Briefing materials prepared by Treasury staff for the Secretary's visit did not advise the Treasury Secretary to issue any cautions to Mexican officials over their exchange rate or macroeconomic policies. Negotiations over expanding Mexico's permanent swap facility with the United States continued during the Treasury officials' February 1994 visit to Mexico.

**March 23, 1994, Through
May 1994: Markets React
to Colosio Assassination,
and Expanded Swap
Facility Created for Mexico**

Treasury officials initially hoped that markets would react calmly to the assassination. A March 24, 1994, Treasury Department memorandum reported no panic in Mexican financial markets and a "broad view" that a Mexican statement reconfirming the existing exchange rate band probably would be enough to keep exchange market pressure in line. The memorandum's author reported telling market participants that Mexico's high foreign reserve levels "did not make a run on the peso very credible." A second March 24 memorandum attached an analysis by an investment

²Expanding an existing currency swap facility between Canada and Mexico also was part of these discussions.

bank. The analysis stated that "if Mexico's central bank declares its intention to sell dollars as necessary to defend the peso . . . the band can be defended without much trouble." A March 25 staff memorandum to the Secretary of the Treasury said that market commentary was "generally positive on the prospects for next week in the absence of a further major crisis."

Immediately after the assassination, both Mexican authorities and the U.S. administration took quick action to try to calm financial markets. As discussed in chapter 2, Mexican authorities allowed the peso to move to the top of its foreign exchange band, raised Mexican interest rates substantially to attract more investment, and offered investors more tesobonos. The U.S. Treasury and Federal Reserve created and, on March 24, announced the existence of a temporary, enlarged, \$6-billion swap facility for Mexico. The facility consisted of \$3 billion in a swap arrangement with the Exchange Stabilization Fund (ESF) and \$3 billion in a swap arrangement with the Federal Reserve. Also, President Clinton and other senior U.S. officials made public statements immediately after the assassination affirming U.S. confidence in Mexico's political and economic stability. A March 25 cable from the U.S. embassy in Mexico City to State Department headquarters credited the announcement of the \$6-billion swap facility as being "key" to reassuring financial markets. Also, on March 24, the Organization for Economic Cooperation and Development (OECD) announced that it would accept Mexico as a member.

Despite these events, however, investor confidence in Mexico continued to lag in April, and the Bank of Mexico continued to expend large amounts of foreign currency reserves. An April 11 Treasury memorandum reported rumors that Mexican authorities had spent \$5 billion intervening on behalf of the peso since the assassination. An April 15 cable from the U.S. embassy in Mexico City reported that a Mexican trade association had estimated that between \$5.2 billion and \$5.7 billion had left Mexico from March 23 to the week of April 11. In fact, by April 20, Mexico held \$18.1 billion of foreign currency reserves, a decline of about \$10 billion since the assassination.

On April 26, 1994, U.S., Mexican, and Canadian authorities finished negotiations to establish a permanent, enlarged currency swap facility, subject to annual review. The permanent trilateral facility between the three countries was created and announced in conjunction with the establishment of the North American Financial Group, a new trilateral consultation mechanism. The swap facility had three components:

creation of a \$6-billion swap facility between Mexico and the United States, with the Federal Reserve and Treasury each participating up to \$3 billion; expansion of an existing swap facility between the Canadian and Mexican central banks to CAN\$1 billion, and renewal of a preexisting \$2-billion swap arrangement between the U.S. Federal Reserve and Canada's central bank. The stated purpose of the swap facilities was to help ensure orderly foreign exchange markets. A senior Federal Reserve official told us that one purpose of the U.S.-Mexican swap facility was to help to reassure financial markets that in the event of a speculative attack on the peso not justified by Mexican economic fundamentals, Mexico would be able to weather the attack without devaluing. Similarly, a Treasury official told us that one purpose of the swap facility was to allow Mexico to weather temporary shocks, including those caused by political events, that were not justified by Mexican economic fundamentals. A second purpose, he said, was to allow time for any Mexican policy adjustments to take effect; i.e., to help Mexico ride out any short-term market disruptions caused by policy changes.

Beginning in late April, Mexican financial markets stabilized. The peso appreciated yet remained comfortably within its trading band. The Bank of Mexico ceased intervening on behalf of the peso on April 22, and foreign currency reserves stabilized at about \$16 billion to \$17 billion through the end of June 1994. Mexico did not draw funds from the swap facility at that time.

The financial crisis that followed the Colosio assassination heightened Treasury officials' concerns about the state of Mexico's economy and the continued viability of Mexico's macroeconomic policies. For example, a March 29, 1994, Treasury staff memorandum concluded that higher U.S. interest rates would have a greater effect on Mexican markets than the current political uncertainty. The memorandum noted that the Mexican government "will increasingly face a dilemma of either (1) losing out on capital inflows because of too small an interest premium or (2) worsening the fiscal deficit due to higher interest costs at a time of expansion in support of electoral politics."

During April, several Federal Reserve and State Department analyses expressed worries about Mexico's financial situation. An April 7 cable from the U.S. embassy in Mexico City informed the State Department in Washington, D.C., that for the first time since November 10, 1993, the Mexican government had been unable to place all the bonds it had offered at auction. As noted in chapter 2, in mid-April 1994, Treasury officials

circulated a paper by economists Dornbusch and Werner. The paper concluded that the Mexican peso was overvalued by about 20 percent and that Mexico should devalue its currency. An April 22, 1994, analysis of the paper by a Treasury official agreed that the peso was overvalued by around 20 percent and concluded that the analysis was "mainstream for this sort of analysis . . . [and] quite good." However, Treasury officials also were aware of an analysis of the Dornbusch/Werner paper that, while concurring that the peso was overvalued, argued that the case for a Mexican devaluation at that time was "weak."

A Treasury official told us that by late April, Treasury's concerns over underlying problems with Mexico's economic situation "had grown another notch." Still, he said, Treasury did not want to see Mexico "derailed" by political events, such as the Colosio assassination at the end of March, which was the big event that had triggered the start of large capital outflows from Mexico. The Treasury hoped that Mexico could get beyond the assassination, which was viewed as a transitory political shock.

In discussions with us, Mexican officials described how they viewed the events of late March and April 1994. They told us that since other Mexican economic indicators were positive following Colosio's assassination, the Finance ministry and the Bank of Mexico expected that the pressure on the peso would be temporary and that foreign investment would return as it had after the November 1993 NAFTA vote. The Mexican officials also asserted that the economic literature at the time held that Mexican interest rates were too high and the Mexican business community believed monetary policy was too tight. In addition, they said that the Mexican government decided at this time to absorb investors' foreign exchange risk by offering more tesobonos. They noted that the government preferred doing this at a time when financial risks may have been perceived by investors to be greater than the Mexican government thought was warranted. Finally, they said that the peso had lost about 10 percent of its value within its trading band during April and May and that the government's action also addressed investor concerns.

On May 8, a senior U.S. Treasury official visited Mexico City and met with the Mexican Finance Minister and the President of the Bank of Mexico. Briefing materials for the U.S. official noted that "Mexico's dependency on the financing of its large current account deficit from largely volatile foreign portfolio investment remains a serious problem." The memorandum predicted that Mexico's current account deficit in 1994

would remain at the 1993 level of 5.9 percent of Mexico's GDP and that Mexico's GDP would grow at a 2-percent rate in inflation-adjusted terms for all of 1994. According to the memorandum, continued capital outflows could hamper financing of Mexico's current account deficit and further drive up Mexican interest rates.

The briefing materials also said that the meeting would provide an opportunity for the Treasury official to "sound out" his Mexican counterpart on recent political and economic developments in Mexico. The briefing materials noted that Mexico probably had lost \$10 billion in reserves since the Colosio assassination, but that financial market volatility recently had moderated somewhat. The materials added that "for the moment [Mexican] government efforts to halt capital flight by hiking interest rates appears [sic] to be working." The memorandum suggested that the Treasury official raise several concerns with Mexican officials involving recent volatility in Mexican politics and financial markets. The U.S. official was urged to ask for an assessment of the situation and a discussion of what actions Mexico would take if world interest rates continued to rise. Also, the memorandum suggested asking for an assessment of the "prospects of further political incidents which might further destabilize Mexico's financial markets."

Documents that we reviewed from late May showed both optimism and pessimism about Mexico's economic prospects for the rest of 1994. A May 28 cable from the U.S. embassy in Mexico City noted that the peso and Mexican financial markets recently had shown more stability. Yet, the cable predicted that markets were likely to be somewhat volatile until the August presidential election, but that the resumption of economic growth in the first quarter of the year, controlled inflation, growing exports, and other factors would provide a "sound environment for long-term growth in corporate earnings." A May 25 U.S. embassy cable reported that most Mexican private sector analysts believed that a Mexican economic recovery probably would occur after the August presidential election. But it also noted that further increases in U.S. interest rates could stymie the recovery, and it reported Mexican concerns over further political instability.

**Summer 1994: U.S.
Officials More Convinced
That Peso Overvalued**

A Federal Reserve paper from July that provided detailed analyses of Mexican exchange rate policies concluded that the peso was overvalued by 5 to 15 percent. However, there does not appear to have been a consensus among U.S. officials in the summer of 1994 that the peso was

overvalued, and, if so, on when financial markets might force Mexico to adjust the peso's value, or the type of adjustment Mexico should try to make. For example, a June 23 Federal Reserve electronic mail message from a senior Federal Reserve official to a staff member indicated that the official was unsure what actions Mexico should take to correct its exchange rate policy, or when it should act. The message stated that "I think we need once again to examine Mexico's exchange rate policy," and it asked, "What is in Mexico's medium-term interest: to try to hold the current band or to permit some adjustment; if the latter, how much?"

A July 17, 1994, Federal Reserve memorandum that reported on a staff member's visit to Mexico stated that there was "general agreement that any change in the exchange rate before the election would be a political disaster." Yet, the memorandum also stated that opinion in Mexico was divided about the viability of the present exchange rate policy in the "medium term" and did not take a position on whether the peso was overvalued. A senior Federal Reserve official told us that by July 1994, he believed that the probability that Mexico would have to adjust its exchange rate policy was "greater than 50 percent." He said he believed that Mexico had two options at that time: a devaluation of 10 percent combined with an increase in the peso's crawl rate, or a doubling of the rate of the exchange rate crawl.

Documents show that during June and July 1994, Treasury, State, and Federal Reserve analysts believed that Mexican financial markets would remain volatile until the August 21, 1994, Mexican presidential election but would then settle down, and foreign investment inflows and Mexican economic growth would resume. For example, in June 3 and June 17 cables, an official at the U.S. embassy in Mexico City predicted that Mexican financial markets would remain "nervous and speculative" until the August election and that foreign investment, both direct and portfolio, would "pick up" after the election. In a June 6 memorandum, a Treasury Department official in Mexico City reported saying in a public speech in Mexico that Mexican economic growth would resume late in the year, following the August election and clarification by the Mexican government of its economic policies. A July 15 Treasury staff memorandum to a senior Treasury official said that "financial markets continue to be strongly influenced by concerns about the outcome of this year's presidential election." In fact, there was substantial selling of the peso between June 21 and July 22, during which Mexico's foreign exchange reserves were drawn down by nearly \$3 billion, from \$17 billion to \$14.2 billion.

July Understanding Reached That Mexico Would Adjust Its Exchange Rate System After the August Election If Conditions Warranted

According to a Federal Reserve document, in early July 1994, Mexican officials asked the Federal Reserve and Treasury to explore with other Group of Ten (G-10)³ central banks whether there would be any interest in reviving a contingency, short-term, financial support facility. According to the document, Mexican officials were not convinced that a devaluation would be necessary but saw the proposed facility as possibly contributing to market confidence in Mexico. The document stated that it was difficult to determine at that time whether a substantial change in Mexico's exchange rate policy was warranted on economic grounds and that a reasonable case could be made either way. Nonetheless, Federal Reserve officials were concerned about the viability of the peso exchange rate policy if pressure continued after the August elections and were even worried that Mexico might have to alter its policy before the election. One G-10 central bank official had also raised concerns about the viability of the peso after the election, the Federal Reserve document said.

According to Federal Reserve documents and U.S. and Mexican officials with whom we spoke, discussions were held in mid-July among the U.S. Secretary of the Treasury, the Chairman of the Federal Reserve, Mexico's Finance Minister, and the Governor of the Bank of Mexico about the proposed swap facility. According to the documents, the Federal Reserve Board Chairman advised the Mexican officials that the United States needed some type of understanding that Mexico would adjust its exchange rate policy after the election in the event that pressure on the peso continued. A few days later, another high-level Federal Reserve official spoke with a high-level official of the Bank of Mexico. According to a Federal Reserve document and interviews with Federal Reserve and Treasury officials, the bank official assured the Federal Reserve official that if pressure on the peso exchange rate continued after the election, Mexican authorities fully intended to adjust their exchange rate policy within a reasonably short period, for example, by the end of September 1994. The Mexican official indicated that he expected that pressure might ease after the election but that if it continued, there would be no way to avoid a revision in Mexico's exchange rate policy. Subsequently, U.S. officials contacted other G-10 governors about Mexico's proposal and got a positive response to establishing a swap facility.

In August, a \$12-billion contingency swap facility was established, with the U.S. monetary authorities agreeing to provide up to half of the amount and

³The Group of Ten are industrialized countries that coordinate monetary and fiscal policies in an attempt to create a more stable world economic system. The group consists of 11 member countries: Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

BIS, backed by other countries' central banks, the rest. The U.S. portion of the facility was to consist of the \$6-billion swap facility created in April 1994. If Mexico chose to announce the new, \$12-billion facility, it would be able to draw upon the arrangement until September 30 for a period of 90 days. All drawings would have to be repaid by December 30. U.S. officials told us that the arrangement was designed in part to allow Mexico to get through the August presidential election.

August Through December 1994: U.S. Officials Advised Mexico That Exchange Rate Was Overvalued, Indicating That Action Was Needed

Uncertainty about the extent to which the Mexican peso was overvalued and about whether and, if so, when Mexico would need to adjust either its macroeconomic policies or its exchange rate policy continued from August through mid-December. Between October and November 20, when Mexican officials met and decided not to devalue, high-level U.S. officials advised Mexican officials that their exchange rate policy was risky and encouraged Mexico to make adjustments to the policy. U.S. officials were concerned because the peso was trading close to the top of the exchange rate band, leaving little room to accommodate additional pressures. In addition, political instability continued, and financial flows had not returned to Mexico. Following November 20, U.S. agencies continued to monitor the peso's deteriorating condition. Analyses provided to us for August through December 20 indicate that U.S. officials did not foresee or judge likely that a forced devaluation would provoke a financial crisis of such magnitude as to require a major financial assistance package from the United States.

August 1 to November 20: U.S. Officials Advised Exchange Rate Was Overvalued

By mid-August 1994, financial markets became more optimistic about the likely outcome of the August 21 Mexican election. Investment outflows from Mexico ceased, and pressure on the peso abated. An August 13 report from the U.S. embassy in Mexico City observed that financial markets were showing optimism over the upcoming election. On August 16, 1994, the Mexican government announced that Mexico's GDP had grown at an annual rate of 3.8 percent during the second quarter of 1994 compared to a year earlier. Treasury Department and Federal Reserve memorandums noted that this growth rate was higher than expected. The memorandums attributed the August surge in investor confidence in Mexico in part to this announcement, although one of the memorandums noted that there was some skepticism about the figure. On August 19, 1994, 2 days before the election, a Federal Reserve memorandum noted that the Mexican peso had ended trading that day at its highest point since early June 1994.

Nonetheless, an August 12 Federal Reserve document said that Dornbusch's assertion that the peso was overvalued by 20 percent "is possibly well grounded by economic fundamentals." On the other hand, a Federal Reserve staff analysis of August 17 said that it was not clear if the peso was overvalued and, if it was, by how much. However, the analysis estimated that the peso was probably overvalued by about 10 percent and cited a range of 5 to 15 percent. The analysis suggested that Mexico would eventually have to devalue due to inflation differentials between the United States and Mexico and the real appreciation of the peso. According to the analysis, the timing could be either over the "short or medium term."

A Federal Reserve analysis of August 19 examined differentials between Mexican and U.S. interest rates to estimate how financial markets were calculating the implied probability of a peso devaluation. The analysis concluded that financial markets perceived only a 6-percent chance of a 20-percent devaluation during the next 3 months and a 15-percent chance during the next year.

A September 23 Federal Reserve analysis reported that about \$40 billion in tesobonos were outstanding, with about half of them held by the Bank of Mexico. According to the analysis, \$685 million worth of tesobonos had matured 2 weeks previously, causing significant pressure on the peso. The paper noted that another \$2 billion in tesobonos would mature on September 29 and speculated about whether Mexican authorities would announce a new Pacto either before or after that date. In fact, as discussed in chapter 2, a new Pacto was announced on September 24 that did not adjust the existing exchange rate policy.

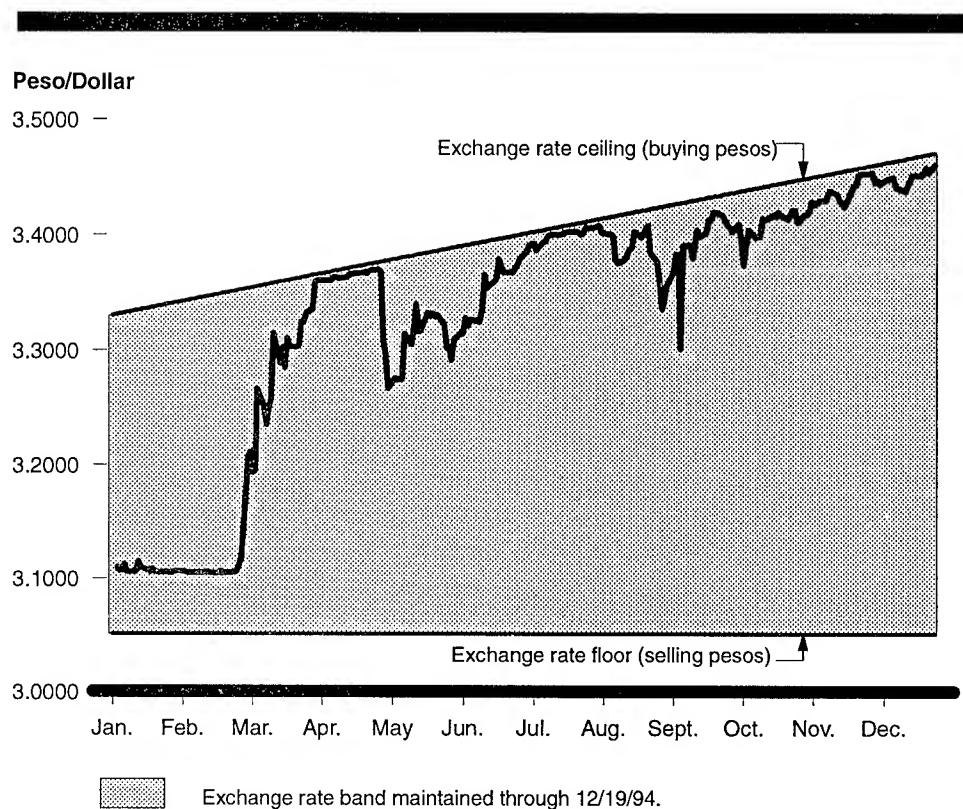
A September 28 Federal Reserve analysis discussed the peso's valuation in terms of the new Pacto. The analysis concluded that President-elect Zedillo's administration had chosen a path of gradual, long-term adjustment rather than immediate adjustment to address Mexico's extremely high current account deficit. (For example, the agreement allowed for only a 6-percent nominal depreciation of the peso through the end of 1995.) The analysis characterized the Pacto's policies as risky on the grounds that they would not produce a reduction in the current account deficit in 1995. The paper characterized the government's inflation target of 4 percent as very ambitious and concluded that the exchange rate policy did not leave the authorities much room to maneuver in the event of renewed pressure on the peso. However, the paper said, if foreign investors maintained confidence in Mexico, the program could allow

Mexico to depreciate the peso gradually and reduce its current account deficit over the next several years.

On September 29, a Federal Reserve staff paper noted that the peso was somewhat overvalued—citing estimates of about 10 percent—but concluded that the government would probably be able to maintain the peso within its band over the next year and without the additional large interest rate increases such as those that took place earlier in 1994. However, the paper warned that the policies needed to reduce inflation further probably would continue to depress economic growth in the near term. In addition, the paper said, the peso would probably remain vulnerable to political shocks such as had been seen earlier in the year. Failure to adjust the peso during 1995 and continued growth in the current account deficit, it said, might create the need for a larger and possibly more destabilizing adjustment in 1995.

By mid- to late October, both the Federal Reserve and Treasury had become quite concerned about the risks and costs of Mexico's trying to defend its exchange rate policy. The peso was trading close to the top of the exchange rate band, leaving little room for further depreciation within the band if pressure on the currency continued. (See fig. 3.1, which shows how the peso traded very close to the top of the band for much of 1994.)

Figure 3.1: Mexico's Exchange Rate Band Intervention Points and Observed Values, January 1, 1994, to December 19, 1994



Note: The shaded area shows the exchange rate band that Mexico maintained through December 19. The upper sloping line of the shaded area represents the ceiling of the band, which was adjusted over time. The Mexican central bank allowed the peso to depreciate gradually at a rate of \$0.0004 per day. As the peso/dollar exchange rate approached the ceiling, the central bank would intervene in foreign exchange markets by buying pesos to keep the peso from further depreciating in value. The line at the bottom of the shaded area represents the floor of the band, which was fixed at 3.0512 pesos/dollar. As the peso/dollar exchange rate approached the floor, Mexico's central bank would sell pesos to keep the peso from further appreciating in value relative to the dollar. On December 20, Mexico announced a 15-percent devaluation of the existing ceiling of the exchange rate band, to 4.0016 pesos/dollar. However, Mexico was unable to defend the band for long. On December 22, it allowed the peso to float. By the end of the year, the peso was valued at 5.325 pesos per dollar.

Source: Bank of Mexico.

On October 20, 1994, high-level Federal Reserve officials met with an official of Mexico's president-elect transition team. According to a written

account of the meeting, the Federal Reserve officials noted that Mexico's credibility in world financial markets had increased tremendously, improving Mexico's ability to achieve foreign financing. However, they cautioned that Mexico's substantial economic progress could be set back by an exchange rate policy that made Mexico vulnerable to a crisis. They suggested that widening or shifting the band might be one way of providing additional flexibility. In response, the Mexican official advised them that the transition team had considered adjusting the exchange rate but had decided against making any changes in the near future. The team intended, he said, to revisit the issue in 1995, once the new government was in place and after the team saw how the economy was evolving. The Federal Reserve officials indicated that that was a risky strategy. They agreed that it was not clear how overvalued the peso was but noted that there was considerable uncertainty in financial markets about the value of the peso. Greater leeway was needed, they said, to allow the peso to absorb possible future financial shocks. If more room were available for the peso to move up or down, they said, the situation would allow for two-way risks for speculators against the peso. Federal Reserve officials told us that they conveyed a similar message at about the same time to Mexico's Finance Minister.

On October 21, 1994, a Treasury staff memorandum to a senior Treasury official noted that the Bank of Mexico had publicly announced its international reserve levels as of October 14 at \$17.2 billion. According to the memorandum, the figure was above market expectations of \$15 billion to \$16 billion and had made a positive impact on trading on the day of the announcement. However, the memorandum noted that the peso had fallen to a record low on October 17, apparently as the result of increased tension in Chiapas. On October 25, a staff memorandum to the Treasury Secretary advised that the peso had fallen in value and was just "a hair away" from the margin at which the Bank of Mexico normally intervenes in financial markets by selling dollars. According to the memorandum, the fall was attributed to several events, including a recent rise in U.S. interest rates, the maturation of a large number of tesobonos, and a TELMEX (Mexico's third largest company) announcement of disappointing third-quarter earnings. The memorandum concluded that the peso appeared to remain quite vulnerable.

According to a briefing memorandum prepared for an October 27 meeting of the Secretary of the Treasury with Mexico's Finance Minister, Treasury was concerned that Mexico's exchange rate system could inhibit economic growth and widen the already substantial current account deficit. The

memorandum noted that hopes for a stable post-election period and a resumption of capital flows into Mexico had not materialized. The September 24 announcement of a new Pacto, it said, had not had the desired effect of strengthening the peso; it was soon offset by renewed concerns over political stability as a result of the September 28 assassination of PRI's Secretary General Ruiz Massieu. In addition, the memorandum observed, the PRI appeared to be beset by an internal struggle between reformers and old-liners, and tensions had recently increased in Chiapas. Although capital flight seemed negligible, so too was additional foreign portfolio investment. In addition, the memorandum advised that although the market had seemed pleased with Mexico's October 14 announcement of \$17.2 billion in international reserves, Mexican financial officials would be hard-pressed to keep reserves at or above that level.

In connection with the latter point, the memorandum indicated concern that Mexican officials might request an activation of the U.S.-Mexico swap facility on the occasion of their next public announcement of foreign exchange reserves (possibly on November 1) if the level of reserves was not as high as it had been on October 14. The document indicated that Treasury would need to carefully consider such a request because the result could be to mislead the market⁴ and that Treasury would want to explore future reforms as part of any activation. The memorandum suggested that the Secretary advise the Finance Minister that Treasury remained concerned about Mexico's exchange rate policy because it left little room to accommodate additional pressures with the peso remaining so close to the top of the exchange rate band.

The memorandum also indicated that Treasury staff thought Mexico had made a commitment in July to change its exchange rate when the United States had lined up European support for a swap facility. However, high-level U.S. officials advised us that Mexico's July commitment was superseded following the August presidential election when substantial pressure on the peso did not develop.

A November 7 Federal Reserve analysis reviewed key factors and events that had influenced Mexican financial markets between September 27 and November 7. The analysis concluded that much of the earlier period had been disillusioning for Mexico and its financial market participants. Although the national election and the renewal of the Pacto were out of

⁴A memorandum prepared on October 19 for the Federal Reserve Chairman showed that the Federal Reserve officials suggested that Mexican officials be counseled that they could not count on using U.S. swap facilities to sustain an inappropriate exchange rate.

the way, most market participants had expected a rosy future of an appreciating peso and declining interest rates—in spite of uncertainty about U.S. interest rates and a heavy maturity schedule for Mexico's dollar-indexed tesobonos. According to the memorandum, the assassination of the PRI Secretary General and a subsequent linking of party members in the murder plot had deepened concerns about party factions and resistance to change. Further, it said, the peso remained under pressure for most of the period as capital was not entering the country as quickly or in as great a quantity as had been hoped for following the election and the Pacto agreement. Foreign investors had become more careful concerning Mexico, and daily dollar/peso volumes had thinned dramatically.⁵ This trend was given added strength, the memorandum said, by rising interest rates in the United States, which increased pressure on Mexican interest rates and the Bolsa. The analysis noted that \$2 billion in tesobonos had matured during the last week of September, that \$4.1 billion had matured in October, and that \$2.8 billion were scheduled to mature in November. The analysis further noted that Mexican corporate earnings releases had shown mixed results.

The November 7 analysis expressed surprise at the market's resilience and the continued credibility of Mexico's currency bands and noted that the Bank of Mexico had not had to intervene even once from September 27 to November 7. The analysis further stated that on October 19, Mexican foreign exchange reserves had been announced at \$17.2 billion, and on November 1, reserves were announced as slightly higher, at \$17.24 billion. Looking to the near-term future, the analysis said that market participants were anticipating the December 1 inauguration of Zedillo as president and that, barring additional "unexpected" political events or shocks, the market was not expecting activity to pick up substantially before the beginning of 1995. Mexican markets would continue to be influenced by major changes in the United States and its markets. The analysis also anticipated that foreign investors would gradually send new capital to Mexico.

A substantial run on the peso began November 14. The Bank of Mexico intervened in the foreign exchange market for the first time since August 16 (when it had sold \$25 million for pesos) and before that on July 21 (when it had sold \$100 million for pesos). Meanwhile, for domestic monetary policy reasons, the U.S. Federal Reserve Board's FOMC met on

⁵A November 10 staff memorandum prepared for a senior Treasury official noted that U.S. interest rates were rising relative to both cetes and tesobonos, narrowing the differences that had favored Mexican assets. The memorandum noted that this development might be contributing to some reduction in foreign portfolio investment in Mexico.

November 15 and decided to raise the U.S. federal funds rate by 0.75 percent. According to a Federal Reserve official, Mexico made an important technical mistake on that day by not raising its interest rates to offset the increase in U.S. rates. As a result, the official said, Mexico lost a considerable amount of its foreign currency reserves. At this point, according to the official, the consensus view at the Federal Reserve was that Mexico would be forced to make an adjustment within a matter of "days, weeks, or months." (According to Bank of Mexico figures, Mexico's foreign reserves were drawn down \$3.4 billion between November 14 and November 18. Most of the drawdown occurred between November 16 and 18.)

A November 16 Federal Reserve document reported that the peso was under pressure and the Bank of Mexico was selling dollars. According to the document, market participants were expressing concerns that interest rates were not high enough to attract capital needed to fund the current account deficit, but higher rates would be detrimental to economic growth. A Federal Reserve document of November 18 reported that Mexican markets were in turmoil because of rumors about Chiapas and the political situation with PRI. It reported that the trade deficit was up, and the current account deficit was causing increased concern and contributing to foreign exchange reserve losses. In addition, the analysis said, the U.S. market and other financial markets were looking more attractive to investors. The document concluded that there was a real question about the sustainability of the Mexican situation.

Mexican authorities met on the weekend of November 19 and 20 to decide whether to adjust Mexico's exchange rate policy and consulted with U.S. officials several times. According to U.S. officials, the Treasury Department advised the Mexican Finance Minister that there was little alternative to changing the policy and that the Chairman of the Federal Reserve shared this assessment. According to Treasury Department documents that we reviewed, the Secretary advised the Mexican Finance Minister during the weekend that it was Mexico's choice whether to alter its exchange rate system. The documents said that the Treasury Secretary thought that the Mexicans would eventually have to allow the peso to depreciate and would have preferred that they had done so during the weekend. According to the records, the Mexican officials had considered devaluing during that weekend but had rejected the option because they felt the political situation would not allow it. Chiapas was cited as one factor; the need for labor support another. Mexican officials decided

against adjusting the exchange rate policy at that time.⁶ On the evening of November 20, President-elect Zedillo went on Mexican television and announced that he supported maintaining the existing exchange rate policy and Pacto.

**November 21 to
December 20, 1994**

Between November 21 and December 20, U.S. officials continued to closely monitor peso developments. Documents that we reviewed for the period through December 15, 1994, showed that although U.S. officials thought that Mexico would eventually have to adjust its exchange rate or macroeconomic policy, they were not convinced that an adjustment would have to be made before 1995. There was no indication in the documents we reviewed that U.S. officials thought a forced devaluation of the currency would lead to a severe financial crisis requiring a major assistance package. The absence of any such indication in the documents was confirmed by officials. For example, a Treasury official told us that when Mexican officials decided not to devalue, following their meetings on November 19 and 20, he felt they were making a mistake. However, he had no idea that the consequences would be so immediate or—after they did devalue—so devastating. Barring Mexico's adjusting its exchange rate or macroeconomic policy, U.S. officials were reluctant to allow Mexico to use its swap facility to support the peso.

On November 21, a senior Treasury official advised the Secretary that the peso had been slightly stronger in early morning trading following Zedillo's reaffirmation of the Pacto and the existing exchange rate policy. He noted that traders had indicated some disappointment that Zedillo's statement had not had a more positive impact and that the Bank of Mexico had raised its overnight lending rate. He also noted that there were reports of violence in Chiapas and fears of violence following victory by PRI's candidate in the Tabasco state gubernatorial race.

In a November 22 memorandum, a senior official again advised the Secretary that Zedillo's television appearance on November 20 appeared to have calmed Mexico's foreign exchange market but noted that it was too early to say that near-term market sentiment on the peso had been reversed. If missteps were avoided, the official said, the current exchange

⁶According to an account by Mexico's then Finance Minister, high-level Mexican officials who met on November 20 were initially divided on what to do—with some favoring an immediate devaluation of 10 to 15 percent, some favoring letting the exchange rate float, and some supporting a drastic tightening of monetary policy to increase interest rates significantly. According to the account, they eventually reached consensus not to devalue if a reaffirmation of the Pacto stopped the speculative attack on the peso. See Pedro Aspe, "Mexico's Ex-Finance Minister Sets the Record Straight," Wall Street Journal (July 14, 1995).

rate should be maintainable through the December 1 inauguration of Zedillo. Looking further ahead, he said, there was a significant risk that pressure on the peso might resume and that Mexico would be forced to make an adjustment to the exchange rate band within which the peso was trading. The official advised the Secretary that he and his staff did not believe it would be useful for Mexico to draw on its swap line to defend an overvalued peso. In addition, he informed the Secretary that the results of a Mexican auction of tesobonos on November 22 suggested that investors saw some increased risk of a devaluation. However, on the same day, a U.S. embassy official in Mexico City advised Washington that he had spoken to a number of sources in Mexico who had concerns about the peso over the short term but still expressed confidence that the Mexican government would not devalue the peso. In addition, he said, his sources were optimistic about the peso for 1995.

According to a talking points paper prepared for a November 23 meeting between the Treasury Secretary and President-elect Zedillo, the Treasury Secretary was advised to tell the President-elect that Mexico's current account deficit was clearly giving financial markets reason for concern about Mexican competitiveness. If Zedillo were to ask about using the swap line with the United States to support the peso, the Secretary was advised to tell him that it would not be helpful to draw on the swap at that time. If Zedillo were to ask the United States to support the peso directly, the Secretary was advised to tell him that that was not a viable option, given the market risk attached to the peso in its current band.

A December 8 Federal Reserve briefing on overnight headlines noted that tensions were rising in Chiapas as peasant groups and guerrilla leaders warned of military action in a bid to prevent the ruling party's Governor-elect, Eduardo Robledo, from taking office. The briefing paper said that Robledo had been elected with 50 percent of the vote in the August election, but opposition parties and rebel chiefs had claimed massive fraud.

A December 15 Federal Reserve briefing report on overnight developments noted that President Zedillo, in a nationally televised address, had stated that the Chiapas conflict represented a constant threat to public calm, peace, and justice, and he had instructed the Mexican Congress to form a multiparty commission to negotiate with EZLN. A December 15 Treasury memorandum for a senior Treasury official reported that the peso had weakened from the previous day and said that the decline could be due to the rejection of renewed peace negotiations by

the shadow opposition government in Chiapas and possibly also to a December 15 Wall Street Journal article on the weakness of the peso.⁷ The memorandum noted that Mexico's reserve assets might have fallen well below \$12 billion. On a positive note, the memorandum said that the volume of activity on the foreign exchange market was low and was likely to drop even further as Mexicans took a long break over Christmas. This, the document said, should help ease pressures on the peso for the next several weeks.

A Federal Reserve analysis covering the November 15 to December 15 period concluded that Mexican policymakers arguably were reaching a juncture in which funding Mexico's current account deficit (estimated at \$28 billion, or approximately 8 percent of GDP) would require that interest rates increase significantly, which could dampen growth prospects, or that the peso be allowed to depreciate at a greater rate. The analysis noted that rising U.S. short-term interest rates had put upward pressure on Mexican rates and had weighed on Mexican corporate earnings. Drops in the U.S. stock market and in U.S. long-term bond prices, it said, had spilled over into the Mexican stock market. And competition for capital by countries such as Brazil had grown significantly over the period. According to the analysis, the peso had traded during the period near the level at which the Bank of Mexico normally intervened, prompting more than \$4.8 billion in sales by the Bank.

With regard to Chiapas, the analysis said that Robledo had taken office on December 8 amid widespread protest, including a declared end of the cease-fire by rebels and the claim of a leading opposition candidate to hold the office of "parallel" governor. No major violence took place, and the market had reacted well at the time, the document said; however, tension was reignited during December 13 through 15 with the Zapatista threat of imminent war and subsequent false rumors of shooting. The Mexican stock market fell to a 4-month low. Looking to the end of 1994 and the first quarter of 1995, the analysis forecast ongoing upward pressure on Mexican interest rates and said that the peso might continue to trade close to the upper limit of the band. Decreasing portfolio allocations to Mexico were likely to continue, it said.

A December 19 Treasury memorandum expressed concern that Mexico might move to change its exchange rate policy before Christmas and without consulting Treasury. The document urged that the Treasury contact Mexico before this occurred. According to the document, Mexico's

⁷Craig Torres, "Foreign Exchange: Peso's Plunge Rocks Confidence in Investing in Mexico."

foreign reserves might have fallen to below \$11 billion⁸ as the week began. According to the memorandum, investors were not worried about the size of the current account deficit or a devaluation but about Chiapas and the possible spread of political unrest. Thus, the memorandum said, a devaluation by the Mexican government would not necessarily lead to a resumption of capital inflows. The document predicted that if foreign investors started to extricate themselves from Mexico, it would be a matter of days before Mexico took some type of action.

Written remarks for the Federal Reserve's December 20 FOMC morning meeting, prepared before the Federal Reserve had learned that Mexico had devalued its peso, indicated that Federal Reserve officials expected an announcement on December 20, as well. However, this document said that the Federal Reserve was not certain whether the change would be a discrete adjustment in the band or a float of some kind.

Should the Administration Have Provided More Forceful Advice to Mexico?

Some observers have argued that, during 1994, U.S. officials should more forcefully have conveyed their concerns over Mexico's economic and financial situation to Mexican officials or that the U.S. officials should have publicly revealed these concerns. We found no clear evidence from our documentary review or interviews indicating that at any given time in 1994, U.S. officials found the evidence and analyses that the peso needed to be devalued sufficiently compelling for them to provide more adamant advice than they did to Mexico. Also, U.S. officials had confidence in the competence of Mexican economic management and were sensitive that because Mexico is a sovereign country, decisions on whether and how to change Mexican economic policies ultimately rested with Mexico. In addition, documents and interviews with U.S. officials indicated that U.S. officials did not foresee that if Mexico were later forced to devalue because of failure to act in a timely way, the consequences would be as severe for Mexico and for other developing countries as they turned out to be. One reason U.S. officials did not publicly discuss their concerns over Mexico's financial situation was because they were concerned about provoking a sudden flight of capital from Mexico.

Difficulty in Arguing With Certainty That the Peso Should Have Been Devalued

It is not apparent from the evidence we reviewed that at any time during 1994, the case that the peso was overvalued and should be devalued was so compelling that U.S. officials believed they could argue that they were certain that Mexico should devalue. One U.S. official told us that Mexican

⁸According to Bank of Mexico data, reserves were \$11.1 billion on Friday, December 16, and reached \$10.5 billion on Monday the 19th.

officials' arguments for not devaluing the peso seemed plausible for much of the year and that the U.S. government was more convinced that a devaluation was necessary than was IMF. As chapter 2 discusses, the fact that drawdowns in Mexico's foreign currency reserves tended to come after unexpected political events, such as the Colosio and Massieu assassinations, would have lent credibility to the Mexican view. Also, as discussed earlier in this chapter, various U.S. government analyses differed over whether the peso was overvalued and, if so, whether and how Mexico should devalue. A Treasury official told us that Treasury lacked the "hard evidence and economic analysis" that would have allowed it to argue firmly in its discussions with Mexican authorities that devaluation was the only course to address the current account deficit. Also, he said, no country had experienced the kind of meltdown that happened to Mexico at the end of 1994 and that Treasury did not anticipate such a meltdown.

Further, U.S. officials did not sufficiently focus on the possibility that if Mexico were to devalue, investors might panic and cease rolling over (reinvesting in) tesobonos, and thus drive Mexico to the brink of default. By the beginning of December 1994, Mexico had tesobono obligations of \$30 billion due in 1995, while foreign exchange reserves had fallen to \$10 billion. As discussed earlier in this chapter, a few analyses that we reviewed pointed to the increasing levels of tesobono obligations, but they did not specifically raise the possibility of such a rollover problem. A Federal Reserve official told us that, in hindsight, Federal Reserve officials assumed that Mexico would be able to roll over tesobonos completely, but that they should have considered the possibility that investors would seek to redeem all the tesobonos. Similarly, a senior Treasury official said that if Treasury officials had focused more on tesobonos, this might have led them to pay more attention to the potential rollover problem and the possibility of default.

Moreover, U.S. officials pointed out that the differential between interest rates on Mexican and U.S. government securities indicated that financial markets perceived a low likelihood of a Mexican devaluation or default during much of 1994.⁹ As previously discussed, a Federal Reserve analysis of August 19, 1994, evaluated differentials between interest rates on

⁹The interest rate carried by a sovereign government debt security reflects different kinds of risk that the purchaser of the debt bears, including the risks that the country will (1) devalue its currency, often called the "foreign exchange risk"; and (2) default on the debt, usually called the "transfer" or "default risk." Comparing the differential between Mexican and U.S. government debt securities over time in 1994 can indicate whether investors' perception of the risk of a peso devaluation or Mexican government default on these obligations was increasing or decreasing.

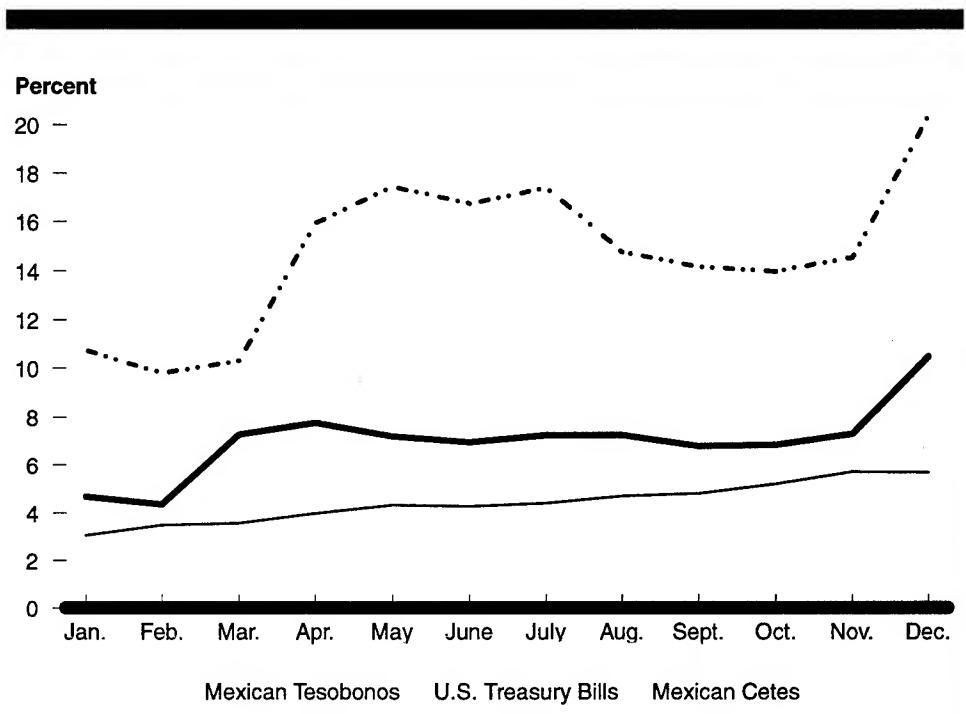
Mexican cetes and U.S. Treasury bills to estimate how financial markets were calculating the implied probability of a peso devaluation. The analysis concluded that because the differential was fairly small, financial markets perceived only about a 6-percent chance of a 20-percent devaluation during the next 3 months and a 15-percent chance during the next year. The analysis also estimated financial markets' perceptions of a Mexican government default on its tesobono obligations that would cost investors about 20 percent of the value of their tesobonos.¹⁰ The analysis estimated financial markets' perceptions of a default on tesobonos to be about 4 percent over the next 3 months and 16 percent over the next year.

Further, as figure 3.2 shows, from August to the end of October, the differential between cete and U.S. Treasury bill interest rates, and between tesobono and U.S. Treasury bill interest rates, narrowed. This implies that financial markets' perceptions of a Mexican government devaluation or default on its dollar-linked tesobono obligations were diminishing.

¹⁰The analysis assumed that were the Mexican government to devalue the peso by 20 percent and then suspend the indexation of tesobonos to the peso-dollar exchange rate or the convertibility of tesobonos into their equivalent value in dollars, this would be equivalent to an act of default that would cause investors to lose about 20 percent of the value of their tesobonos.

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Figure 3.2: Yields on Mexican Cetes, Tesobonos, and U.S. Treasury Bills, 1994



Note: Tesobono and cetes data are end-of-month data. U.S. Treasury bill data are monthly averages.

Sources: Bank of Mexico, U.S. Treasury Department.

Other Reasons for Not Providing Stronger Advice

A Senior Treasury official has testified before Congress that because Mexico is a sovereign country, the United States cannot force policy choices upon Mexican officials. In addition, our review of Treasury, State Department, and Federal Reserve documents and interviews with agency officials indicated that U.S. officials did not foresee that the Mexican devaluation would lead to a sudden, virtual abandonment of Mexico by foreign investors and a threat of imminent default by Mexico on its nonpeso-denominated debts. For example, a senior Treasury official told us that as 1994 progressed, Treasury saw a growing risk that the markets would force a devaluation of the peso. However, he said, if a devaluation occurred, he did not believe that Mexico would experience the kind of crisis that would bring it to the brink of default, like the Mexico crisis of 1982. Another Treasury official told us that by mid-December Treasury

expected that a modest devaluation would occur and that if Mexican interest rates were high enough, the situation would stabilize. The official said that he thought that the adjustment needed to stabilize Mexican financial markets was considerably less than the 15-percent devaluation implemented by Mexico on December 20. Similarly, a Federal Reserve official told us that he was "very surprised" that the 15-percent devaluation of December 20 did not hold, because he believed that only a 10-percent devaluation was necessary to stabilize financial markets.

Also, U.S. officials did not anticipate that Mexican authorities would mismanage the December 20 devaluation and thus exacerbate the devaluation's effect on investor confidence in Mexico. In March 10, 1995, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, a senior Treasury official attributed the December 1994 financial crisis in part to Mexican authorities' "mishandling" of the devaluation.

Some observers have also argued that administration officials should have publicly aired their concerns during 1994 over Mexico's economic situation and policy course. They assert that the administration had an obligation to provide the public with its assessment of whether the peso was overvalued and what actions Mexico should have taken to correct its financial situation—especially in light of the fact that Mexican authorities had chosen not to adjust their policies despite administration counsel to do so. A principal reason why U.S. officials did not publicly discuss their misgivings about Mexico's financial situation was out of concern that such statements could cause investors to suddenly withdraw funds from Mexico, triggering financial difficulty for Mexico. Also, it is not clear that the U.S. government possessed any information in 1994 on Mexico's financial situation that private financial markets did not have or were not capable of piecing together from their own sources.

A senior Treasury official told us that he did not believe that the Treasury had important, substantive information that financial markets did not have. The official said that data on Mexico's current account, interest rates, and overall amounts of tesobonos outstanding were public. It was a little hard to know what the markets knew about Mexico's foreign exchange reserves on a moment-to-moment basis, he said, but the markets seemed to be aware of broad trends in Mexico's reserve levels. According to the official, Treasury's assessment of Mexico's situation differed from that of financial markets, but markets have their own way of processing information and are capable of drawing different conclusions. The official said that he did not think it would be appropriate for Treasury to take a

public position about whether or not a foreign currency was overvalued. At the same time, he said that emerging market countries need to disclose publicly more financial information and do so more frequently, so that market participants can make their own judgments.

IMF Advice to Mexico

IMF completed a major review of Mexico's foreign exchange policy and economic policies in February 1994. The review did not indicate a need to change the policy. Further, Treasury and IMF officials told us that IMF eased off its surveillance of Mexico during the second half of 1994 when the foreign exchange reserves appeared to have stabilized after the sharp drop in the spring, did not foresee the crisis, and did not see a compelling case for Mexico to alter its exchange rate policy before the December 20, 1994, devaluation.

February 1994 IMF Article IV Consultation

IMF typically holds consultations every year with each of its members to obtain information on whether the member country is acting responsibly and openly in setting the conditions under which its currency is bought and sold by governments and private citizens of other countries, as well as information on the country's overall economic position. This process is referred to as an "article IV consultation," since it is related to article IV of the IMF Articles of Agreement.

As part of the process, a team of IMF staff members is to travel to the country's capital and spend several weeks gathering information and holding discussions with government officials about the country's economic policies. The process includes discussions with high-ranking government officials to find out how effective their economic policies have been during the previous year and what changes might be anticipated during the coming year. They also are to inquire about what progress the country has made in eliminating whatever restrictions it has on the exchange of its currency. When these meetings are over, the team is to return to headquarters in Washington, D.C., to prepare a detailed staff report for discussion by the IMF executive board. The IMF Executive Director of the country under review is to take part in the discussion, clarifying points about the country's economy and listening to the evaluation by other executive directors. A summary of the discussion, often containing suggestions about how to strengthen areas of economic weakness, is later to be transmitted to the member's government.

During February 1994, IMF executive directors met to discuss Mexico's article IV consultation. According to IMF, the consultation took place against a background, during 1993, of a continued surplus in public finances, a reduction in inflation, and further progress in structural reform, as well as a decline in the external current account deficit by more than 1 percentage point, to 5.7 percent of GDP.¹¹ IMF noted that Mexico's current account deficit was more than covered by capital inflows. During the discussion, the executive directors expressed satisfaction with Mexico's narrowing of the external current account deficit in 1993, which was attributed in part to Mexico's economic slowdown and the unwinding of the consumption boom of the past few years, as well as to a rapid growth in nonoil exports. Executive directors stressed Mexico's need to lower the deficit further with the aid of policies designed to strengthen private savings and to maintain high levels of public savings. According to IMF, some directors expressed concern about the outlook for Mexico's competitive position, but it was generally noted that notwithstanding the real appreciation of the peso in recent years, Mexico's manufacturing exports continued to register strong gains. However, since further real appreciation of the peso could pose risks to the continued export expansion, directors emphasized the importance of Mexico's lowering inflation, restraining wages, and continuing structural steps to ensure export market competitiveness and labor market flexibility.

According to a Treasury Department official, during the article IV consultation in February 1994, the United States expressed concern about the size of Mexico's current account deficit and GDP growth. The official said that IMF staff acknowledged concerns about Mexico's lack of growth but argued that Mexico's peso valuation was acceptable. Although some economists were arguing that the peso was overvalued, the official said, most economists and IMF staff believed that Mexico's rising level of exports meant that the peso was competitive. IMF staff noted that Mexico had balanced its budget, had gotten inflation under control, and had begun to restructure its economy by liberalizing trade and privatizing its industries. In addition, staff indicated that capital inflows showed investors were confident about Mexico.

**IMF Did Not Foresee
Mexico's Crisis**

According to a senior IMF official that we interviewed, IMF staff did not closely monitor Mexican developments during the latter half of 1994 and, like other informed observers, did not predict the crisis. The official said

¹¹1994 International Monetary Fund Annual Report, IMF (Washington, D.C.: Apr. 30, 1994).

that IMF had done a post-crisis study to determine why it had missed the crisis. Among reasons cited by the official were the following:

- IMF was not monitoring countries on a “real-time” basis. For example, staff were not tracking real-time data on Mexican tesobonos during 1994.¹²
- IMF had become too tolerant of a fall off in the quality and timeliness of data provided by member countries that were no longer in an IMF-supported adjustment program. Mexico had not had a program with IMF since May 1993.
- Mexico had a very well-respected economic team, including its Finance Minister. IMF staff tended to give Mexico the benefit of the doubt.

A Treasury official that we interviewed cited several reasons why IMF failed to foresee Mexico's exchange rate crisis.

- The IMF article IV consultation occurred before the crisis developed. Mexico's 1994 consultation took place early in the year, well before the December crisis. Although some other discussions were held between IMF staff and Mexican officials during the year, there clearly was a need for more monitoring.
- Timely reporting of some data by Mexico was lacking. This was a problem with many member countries. IMF staff did not aggressively seek information; they waited for member countries to provide it.
- IMF staff were not paying enough attention to external market borrowing by countries. IMF country evaluations focused too much on examining whether the fiscal account was balanced and did not focus enough on private markets.
- IMF staff doing financial market analysis were working independently from IMF country teams.

According to the Treasury official, although IMF failed to predict the crisis, it was not alone. According to the official, major investment firms were advising clients to invest in Mexico as late as November 1994, saying that the government of Mexico was committed to not devaluing the peso. In addition, the official said, reasons offered by the Mexican government for not devaluing the peso were plausible throughout the year.

According to the Treasury official, the most important event that IMF staff and Mexican officials missed in their analyses during the year was the rise in U.S. interest rates and how that affected investment in Mexico. U.S. interest rate increases coincided with important political shocks that

¹²According to the official, IMF is making progress in developing a real-time surveillance capability.

occurred in Mexico during the year. According to the official, analysts attributed the decline in financial flows into Mexico primarily to the political events. But, the official said, rising U.S. interest rates changed the investment calculation for most investments.

Conclusions

We found that Treasury, State Department, and Federal Reserve officials had some concerns about Mexico's ability to sustain the peso's valuation in early 1994 due to Mexico's large current account deficit and the real appreciation of the peso relative to the dollar during the preceding several years. However, at that time, Mexico was attracting large flows of foreign capital and had sizable foreign currency reserves. Concerns increased following the Colosio assassination as large amounts of Mexican reserves were drawn down. However, the U.S. officials thought the peso exchange rate was still sustainable and made swap facilities available to help Mexico maintain orderly exchange rate markets. In July, the United States and BIS, backed by other countries' central banks, organized a large contingency swap facility designed in part to help get Mexico through its August election. U.S. officials were sufficiently concerned by that time to secure an oral understanding from Mexico that if pressure on the peso continued beyond the election, Mexico would make some adjustments.

Substantial pressure on the peso did not resume following the election; however, capital inflows also did not resume, as had been expected by Mexican officials. During October and November 1994, U.S. officials advised Mexican officials that they believed the peso probably was overvalued and that it was a risky strategy to try to maintain the existing exchange rate policy. However, Mexican officials chose not to adjust the exchange rate policy at that time. Immediately following the renewed attack on the peso and substantial drawdown of Mexican foreign currency reserves during the third week of November, U.S. officials indicated that they thought Mexico did not have much alternative to adjusting its exchange rate and had discussions with Mexican officials about Mexico's policy options. By mid-December, U.S. officials were expecting that Mexico would be forced to devalue its currency in the near future, but not necessarily before the end of the year.

U.S. officials had several reasons for not having given stronger advice to Mexico to devalue the peso in 1994. The evidence that the peso was overvalued and had to be devalued was not sufficiently compelling to be persuasive to Mexican authorities. Also, U.S. officials have publicly stated that they were sensitive to the fact that a decision to devalue the peso

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ultimately rested with Mexico and had confidence in the competence of Mexican economic management. Finally, documents indicate that U.S. officials did not foresee that a devaluation would lead to a financial crisis for Mexico and a multibillion-dollar assistance package from the United States.

U.S. and IMF Response to the Crisis

After it appeared that an initial proposed package of \$40 billion in U.S. guarantees would fail to gain needed congressional support, a multilateral response to the Mexican crisis, primarily with United States and International Monetary Fund (IMF) participation, was created. The main aim of this assistance was to help Mexico avoid financial collapse and to limit any spread of the crisis to other emerging market economies. The U.S. portion of the package uses ESF funds and Federal Reserve funds backed by ESF. Treasury has the requisite authority to use ESF to provide assistance to Mexico. In exchange for the assistance, Mexico agreed to abide by terms and conditions specified in the U.S. and IMF assistance packages, including paying interest and fees, providing additional repayment assurance to the United States through a mechanism allowing set-off against revenues from the export of Mexican oil, implementing a comprehensive and stringent economic plan, and providing economic information on a timely basis.

The Initial U.S. Assistance Package

On January 12, 1995, the President announced a proposed \$40-billion loan guarantee package for Mexico and began seeking congressional approval. According to statements by the Secretary of the Treasury, the U.S. government would guarantee payment of up to \$40 billion in new private sector loans to the Mexican government. Mexico was to use these loans to reduce its short-term obligations. In exchange for these guarantees, Mexico would pay a guarantee fee to the United States. The package also provided that Mexico would pay a supplemental interest rate on any guaranteed borrowing above market rates. This higher rate was to encourage Mexico to limit the use of guarantees and return to private capital markets as soon as possible. As with the subsequent package, this \$40 billion of assistance would have been contingent on Mexico's making changes in its economic policies.

The U.S. and IMF Assistance Package

On January 31, 1995, after it appeared that the package would not attain sufficient congressional support, the administration announced in its place a \$48.8-billion multilateral assistance package to respond to the Mexican financial crisis. The U.S. portion of this package included up to \$20 billion in currency swaps and securities guarantees from Treasury's ESF, which the Treasury Secretary may use for certain authorized operations without a congressional appropriation.¹ On the same day, IMF announced an

¹The short-term swaps include up to \$6 billion that may be provided by the Federal Reserve Bank of New York acting at the direction of the Federal Reserve's FOMC. The Treasury Department has agreed to provide backing for these swaps by assuring repayment of any drawings under the \$6-billion swap arrangement.

18-month, \$17.8-billion standby credit arrangement for Mexico. The multilateral assistance package also included \$10 billion from other industrial countries through BIS and \$1 billion from Canada.² It was also originally said to include funds from two Latin American countries and additional loans from commercial banks.³

Objectives of the U.S. and IMF Assistance Packages

The primary purpose of this assistance was to help Mexico overcome its short-term liquidity crisis and thereby prevent Mexico's financial collapse. Treasury, Federal Reserve, and IMF officials believed that providing immediate assistance would limit the effects of Mexico's crisis from spreading to the economies of other emerging market nations and beyond. For the United States, an additional concern was to limit the negative effects of the crisis in the areas of trade, employment, and immigration.

U.S. officials judged that Mexico's imminent financial collapse could be prevented, and investor confidence in Mexico restored, by making available large amounts of money to allow for the refinancing of a large portion of Mexico's maturing short-term liabilities. Specifically, they believed that the package would allow Mexico to redeem debt that was immediately coming due, and refinance debt that would be coming due in the near future, with debt of longer maturity. Further, U.S. officials believed that these actions would prevent Mexico's liquidity crisis from becoming a solvency crisis. The assistance package also allowed the government of Mexico to help Mexican banks meet their dollar obligations. Several Mexican banks had large amounts of dollar-denominated certificates of deposit that were coming due, and the assistance package would facilitate their redemption and avert further deterioration of Mexico's dollar reserves.

Both the United States and IMF were concerned that the loss of confidence in Mexico's economy would spread to other emerging market countries and would disrupt capital flows to these countries. Early in the crisis, financial markets in Brazil and Argentina, among other emerging market countries, were affected by Mexico's problems as investors began to limit capital flows to these countries. According to the Secretary of the

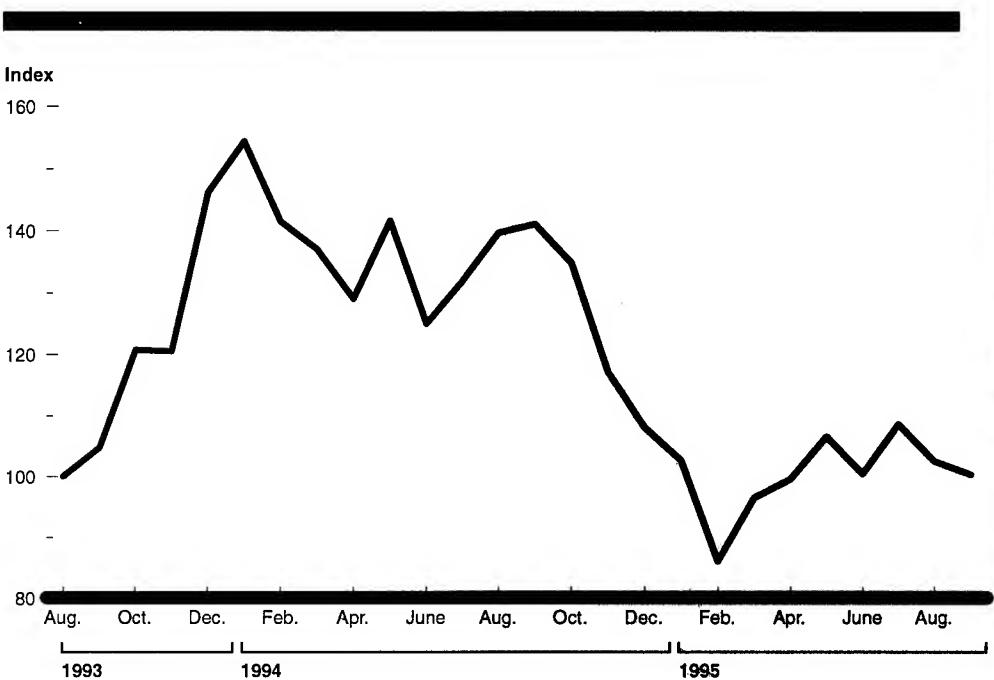
²In early January, BIS announced a \$5 billion facility, which was later increased to \$10 billion. BIS funds were short term and have not been drawn upon by Mexico. The Bank of Canada established a swap facility with the Bank of Mexico as part of an April 1994 trilateral swap facility. By the end of January 1995, the Bank of Canada had already activated its short-term swap arrangement with the Bank of Mexico.

³Initial commitments from Argentina and Brazil for \$1 billion to participate in the assistance package were withdrawn when these countries experienced a reaction from Mexico's crisis, and capital fled. There was also an announcement of efforts to raise funds from a group of international commercial banks and a group of investment banks.

Treasury, as well as government and industry analysts, Mexico has been a paradigm for countries that are striving to put inward-looking, state-controlled models of economic development behind them and move to free market models. The Secretary also noted that new prosperity, based on open markets, encouraging investment, and privatization of state-controlled industries, is beginning to be realized in these emerging market countries. Other U.S. government officials stated that they believed a spread of Mexico's financial difficulties to other emerging markets could have halted or even reversed the global trend toward market-oriented reform and democratization. Senior Federal Reserve officials also stressed that an objective of the package was to halt the erosion in Mexico's financing capabilities. Stock market indexes for emerging markets, compiled by the International Finance Corporation (IFC)⁴ showed that markets in Argentina and Brazil in particular suffered heavy trading losses immediately after the Mexican crisis (see figs. 4.1 and 4.2). Table 4.1 charts the issuance of new equities in selected emerging markets in the period surrounding the Mexican financial crisis.

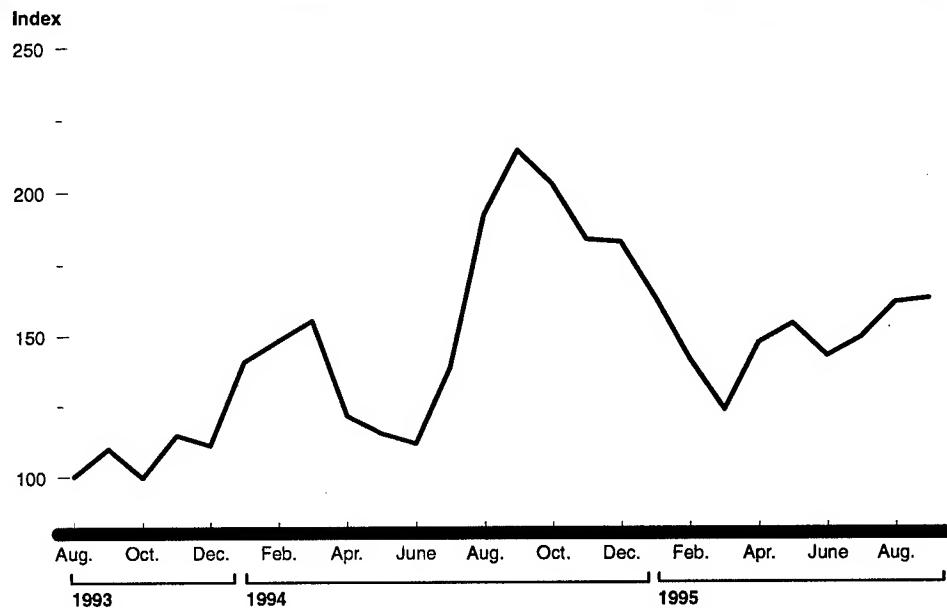
⁴IFC is a member of the World Bank Group and is a large source of financing for private enterprise in emerging economies. IFC also compiles the Emerging Markets Data Base, a statistical resource tracking market information in developing countries.

Figure 4.1: Argentina's Stock Market Index, August 1993 - August 1995



Source: IFC Emerging Markets Data Base—investable index series.

Figure 4.2: Brazil's Stock Market Index,
August 1993 - August 1995



Source: IFC Emerging Markets Data Base—investable index series.

Analysis of stock market trends summarized in table 4.1 shows that there were virtually no new issues of international equities in Brazilian, Argentine, and other emerging markets in the first quarter of 1995.

Table 4.1: International Equity Issues
in Selected Emerging Markets, 1994-95

Country	U.S. dollars in millions				
	1994Q2	1994Q3	1994Q4	1995Q1	1995Q2
Argentina	\$643.2	\$75.2	\$153.0	0	\$146.1
Brazil	138.0	857.4	179.7	0	110.0
Chile	319.0	198.1	195.3	0	0
China	530.6	782.8	832.5	0	496.9
Indonesia	171.9	1,183.2	114.4	0	0
Mexico	898.2	63.2	260.3	0	0

Sources: Euromoney Bondware and World Bank data.

In addition to the U.S. and IMF objectives outlined previously, the United States had other objectives that addressed U.S.-specific interests.

According to the Secretary of State and other U.S. government officials, the United States has a fundamental national interest in making sure that financial confidence in Mexico is restored. Due to growth in the Mexican economy—particularly over the last decade—and the economic interdependence between the United States and Mexico, the United States has both strategic and economic interests in the Mexican economy.

The United States also has an interest in protecting trade with Mexico and thereby limiting U.S. job losses stemming from the crisis. Mexico is the third-largest market for U.S. exports and the third-largest source of U.S. imports. According to the Secretary of State, if the United States had failed to act, U.S. exports to Mexico—now valued at \$40 billion a year—would have been severely affected. Many of the 700,000 jobs those exports support could have been jeopardized in that event.

Based on their belief that immigration from Mexico is inversely related to Mexican economic growth, U.S. officials were also concerned that turmoil in the Mexican economy could be a catalyst for a surge in illegal immigration to the United States. According to the Secretary of State, economic distress and political instability in the wake of the crisis would have added to the pressure that had already pushed thousands of illegal immigrants across the 2,000-mile U.S.-Mexican border. According to one Treasury Department estimate, Mexican illegal immigration to the United States could have increased by as much as 30 percent per year as a result of economic difficulties stemming from a financial collapse in Mexico.

Treasury Secretary Had Requisite Authority to Use ESF Funds

Under the terms of the assistance package, the Secretary of the Treasury committed ESF to lend Mexico up to \$20 billion through the following three mechanisms: (1) short-term currency swaps through which Mexico may borrow U.S. dollars in exchange for Mexican pesos at a specified rate of interest; (2) medium-term currency swaps for up to 5 years; and (3) guarantees for up to 10 years under which Treasury, utilizing ESF funds, would guarantee the payment of all or part of the principal of and interest on securities to be issued by the Mexican government. ESF mechanisms are available in conjunction with the assistance that Mexico has received from other sources, including IMF assistance of up to \$17.8 billion. The stated purpose of the U.S. assistance package is “to assist Mexico in stabilizing its exchange and financial markets by providing resources to be used in such

manner as to facilitate the redemption, refinancing or restructuring of Mexico's short-term debt obligations. . . ."⁵

In connection with the use of ESF funds, the Treasury Secretary received two legal opinions discussing his authority to use ESF. The Treasury Department General Counsel and Department of Justice opinions both concluded that the Secretary of the Treasury had the requisite authority to use ESF to provide assistance to Mexico as contained in the U.S. assistance package.⁶ We have no basis to disagree based on the following analysis.

Use of ESF

Congress established ESF in 1934 pursuant to section 10 of the Gold Reserve Act of 1934 "for the purpose of stabilizing the exchange value of the dollar."⁷ Since its passage, the statute has been amended to broaden its purpose from the stabilization of the dollar to include the promotion of orderly exchange arrangements and a stable system of exchange rates.⁸ In the past, ESF has been used to buy and sell foreign currencies, extend short-term swaps to foreign countries, and guarantee obligations of foreign governments.

As amended, the provision governing the use of ESF provides the following:

"Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary or an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months." 31 U.S.C. § 5302(b).

As set forth in the previous paragraph, section 5302(b) provides broad authority for the Secretary to provide loans and credits, as well as deal in "other instruments of credit and securities." We concur with Treasury's

⁵See section I of the U.S.-Mexico Framework Agreement for Mexican Stabilization, dated February 21, 1995 (framework agreement).

⁶See letter from Edward S. Knight, General Counsel of the Department of the Treasury, to Robert E. Rubin, Secretary of the Treasury, February 21, 1995; and memorandum from Walter Dellinger, Assistant Attorney General of the U.S. Department of Justice, to Edward S. Knight, General Counsel of the Department of the Treasury, March 2, 1995.

⁷This section was codified at 31 U.S.C. § 5302 as part of the permanent codification of title 31 in 1982.

⁸This change responded to the country's move away from the gold standard and a fixed exchange rate. See House Report No. 94-1284, 94th Cong. 2d Sess., 13-14 (1976).

conclusion that the swaps and guarantees fall within this broad authority. The United States has lent money to Mexico through short-term swaps (maturity of not more than 6 months) five times since 1982 and through a medium-term swap (maturity of up to 1 year) once in 1982. In the past 15 years, ESF has extended guarantees three times. Treasury used ESF to provide guarantees to assist Brazil during a financial crisis in 1982 and Yugoslavia in 1983. Later, in 1994, Treasury used ESF to extend a guarantee to assist Macedonia in paying off arrears to the World Bank.

Loan and Guarantee Maturities Permitted Under the Statute

In the Mexican assistance package, the medium-term swaps may have maturities of up to 5 years and the guarantees may remain outstanding for a period of up to 10 years, maturities that exceed all past ESF loans and guarantees. While these maturities are unprecedented, the statute does specifically allow the lengthening of maturities if unique or emergency circumstances exist. In this instance, the Secretary of the Treasury and the President determined that such circumstances existed to warrant the longer maturities. If an ESF loan or credit exceeds 6 months, the statute requires that the President provide Congress with a written statement that unique or emergency circumstances exist. The President provided Congress with this statement on March 9, 1995.

Treasury Secretary Concluded That the Assistance Package Was Consistent With IMF Obligations of the United States

The statute affords the Treasury Secretary, with the approval of the President, the complete discretion to decide when the use of ESF is consistent with IMF obligations of the United States and states specifically that ESF is under the Secretary's exclusive control. The statute further provides that in this regard the "[d]ecisions of the Secretary are final and may not be reviewed by another officer or employee of the Government" (31 U.S.C. § 5302(a)(2)). In deciding to implement the assistance package, the Secretary appropriately exercised the discretion afforded him under the statute.

As required by the statute, the Secretary determined that the assistance package was consistent with IMF obligations of the United States on orderly exchange arrangements and a stable exchange system. These obligations are contained in article IV of IMF's Articles of Agreement, which is its governing document. Article IV, entitled "Obligations Regarding Exchange Arrangements," sets out the monetary policies that IMF members are to follow that affect rates of exchange between domestic and foreign currencies. Under article IV, members agree "to collaborate with the [IMF] and other members to assure orderly exchange arrangements and to

promote a stable system of exchange rates." Particularly, members agree to "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions." The Secretary, consistent with the discretion afforded him under the statute, decided that the assistance package was consistent with these purposes because the Mexican financial crisis had a destabilizing effect on the peso's exchange rate and negative repercussions for the overall exchange rate system. In addition, IMF announced its own assistance package that served the same primary objectives as the U.S. assistance package.

Assured Source of Repayment

Although the statute does not require it, Treasury's policy has been that ESF loans to foreign countries provide a means to assure repayment of any funds lent. This policy helps protect ESF against loss and avoid using ESF as an alternative source of foreign aid.⁹ In an effort to assure repayment of any funds lent under the assistance package were Mexico unable to make timely payments on the amounts due, Mexico has established a payments facility through which the proceeds from regular Mexican oil exports could be set off against to repay unpaid obligations owed to the United States. Treasury and the Federal Reserve have used this type of oil proceeds facility in the past to provide an assured source of repayment in connection with earlier swap arrangements with Mexico. With regard to the current oil facility, which has some features not present in earlier facilities, Treasury concluded that this facility provides a high degree of assurance that the United States will be reimbursed in the event that Mexico were to default on its repayment. This issue is discussed in more detail later in this chapter.

Criticisms of U.S. Assistance to Mexico

Some observers contended that the United States should not have provided financial assistance to Mexico at all. These critics usually based their objections on one or more of three arguments. First, they contended that it was inappropriate for the United States to protect investors in Mexico by preventing a Mexican government default on its short-term debt. They maintained that those investors—including tesobono holders—knew or should have known the risks associated with their investments, and pointed out that, before the crisis, they had been rewarded for that risk with a high return. Consequently, these critics said, U.S. taxpayer funds should not have been put at risk to prevent those

⁹In connection with Treasury's consideration of a loan to Poland in 1989, Treasury took the position that the loan would not be improper or illegal, even if there were no assured source of repayment, if the Secretary concluded that the loan was consistent with U.S. obligations in IMF and was necessary.

investors from bearing the consequences of their actions—even if it meant that Mexico would default on its short-term debts. In fact, it was argued, protecting certain investors in Mexico from financial losses would create a “moral hazard” problem, i.e., it would encourage future investors in Mexico (or even other developing countries) to make riskier investments than they otherwise would have made because they would expect the U.S. government to again come to their rescue should another Mexico-like crisis threaten. Creating this perception on the part of investors, critics alleged, could make future Mexico-like crises more likely.

Second, some people questioned whether the spread of Mexico’s crisis to other emerging market economies posed a substantial threat to those countries or to U.S. investors in those countries. Some critics asserted that the spread that did occur was a temporary market overcorrection that would have reversed itself before it seriously harmed U.S. investors or other emerging market economies. Others contended that the effect of the spread was an appropriate market correction: financial markets had underestimated the risks of investing in certain countries and thus had overinvested there in the first place. Finally, some critics of U.S. financial assistance to Mexico asserted that the threat a Mexican government default on its short-term debts posed to U.S. trade, employment, and immigration was not sufficiently great to justify financial assistance from the U.S. government.

Terms and Conditions of U.S. Assistance Package

On February 21, 1995, the United States and Mexico entered into four financial agreements that would provide Mexico with up to \$20 billion—the framework agreement, the oil agreement, the Medium-Term Exchange Stabilization Agreement (medium-term agreement), and the Guarantee Agreement, which are collectively referred to as “the agreements.” The agreements provide that ESF resources are to be made available to Mexico in the form of short-term swaps, medium-term swaps, and securities guarantees. They are to be used to assist Mexico in stabilizing its exchange rate and financial markets by facilitating the redemption, refinancing, and restructuring of Mexico’s short-term debt obligations. Under the agreements, the provision of these resources is conditioned upon Mexico’s satisfaction of certain economic, monetary, and fiscal conditions, including compliance with the IMF program that is outlined later in this chapter, as well as reporting requirements.

Three Elements of the U.S. Assistance Package

The framework agreement provides that the United States will enter into short-term swap transactions, with maturities up to 90 days and in an aggregate amount up to \$9 billion, through either the resources of ESF or the resources of the Federal Reserve (backed by ESF) or both. As part of the assistance package, the Federal Reserve agreed to increase its swap arrangement with the Bank of Mexico to \$6 billion until January 31, 1996. In exchange, the Treasury has provided the Federal Reserve with assurances of repayment of any drawings under the increased swap arrangement outstanding for longer than 12 months. In these short-term swap transactions (and similarly in the medium-term swap transactions), the United States and Mexico are to exchange a specified amount of each other's currencies and then reverse that transaction at a later specified date. The interest rates applied to short-term swaps are intended to cover the cost of funds to Treasury (or the Federal Reserve) and, therefore, are set at the inception of each swap transaction at the then current 91-day Treasury bill rate. Short-term swaps may be rolled over after 90 days for a new 90-day period, at the new 91-day Treasury bill rate.

Under the medium-term agreement, Treasury and Mexico may enter into medium-term swap transactions, with maturities of up to 5 years, up to an amount that when added to the amount of outstanding short-term swaps and guarantees does not exceed \$20 billion. Interest rates, which are determined at the time of each medium-term swap disbursement, are intended to cover the cost of funds to Treasury and are set at a rate at least sufficient to cover the current U.S. government credit risk cost for Mexico. For each medium-term swap disbursement, the premium is to be the greater of (1) a rate determined by the U.S. government's Interagency Country Risk Assessment System (ICRAS)¹⁰ as adequate compensation for the sovereign risk of Mexico; or (2) a rate based on the amount of U.S. funds outstanding to Mexico from short-term swaps, medium-term swaps, and guarantees at the time of disbursement. This rate is between 225 basis points¹¹ (if \$5 billion or less is outstanding) and 375 basis points (if \$15 billion or more is outstanding). Mexico is required to maintain the dollar value of peso credits to the United States, adjusting the amount of

¹⁰ICRAS seeks to uniformly evaluate for the executive branch the country risk contained in foreign loans and guarantees. Each year an interagency committee devises uniform country risk interest rate premiums for other countries. The Office of Management and Budget requires executive branch agencies to calculate the costs of foreign loans and guarantees using annually updated ICRAS ratings and country risk interest premiums when foreign loans or guarantees are budgeted, authorized, disbursed, or modified.

¹¹A basis point is the smallest unit used in quoting yields on bonds, mortgages, and notes. A basis point is equal to one one-hundredth of one percentage point.

pesos on a quarterly basis, to reflect changes in the peso-dollar exchange rate.

Finally, ESF funds may be used to guarantee the payment of all or part of the principal of and interest on debt securities denominated in U.S. dollars to be issued by the government of Mexico in an amount that when added to the amount of outstanding short-term and medium-term swaps does not exceed \$20 billion. No guarantee may be issued with respect to principal or interest payments due more than 10 years after the date of issuance of the debt securities. The swaps and guarantees may be disbursed during a period of 1 year, with an optional 6-month extension, after the effective date of the framework agreement. Under the guarantee agreement, Mexico is to pay to the Treasury Department a guarantee fee calculated using a present value formula. The variables in the formula include the amount to be guaranteed, the maturity of the debt securities, Treasury's borrowing rate for the same maturity, Mexico's cost of borrowing with the guarantee, and an appropriate credit risk premium, which is the greater of the ICRAS premium, or 225 to 375 basis points, depending on the total amounts of swaps and guarantees outstanding. As an example, if the United States were to guarantee \$8 billion of debt securities issued by the government of Mexico, the agreement provides for Mexico to pay the Treasury Department a guarantee fee of about \$1.9 billion.¹²

The Oil Agreement

The oil agreement provides a source of repayment for support under the assistance agreements. It sets forth the rights and responsibilities of various parties as to the use of proceeds from the export of crude oil and oil derivatives by PEMEX. It is to remain in place until all of Mexico's payment obligations under the assistance agreements have been fully satisfied.

The Bank of Mexico has established a special funds account at the Federal Reserve Bank of New York as required under the oil agreement. The amounts received by PEMEX into its private bank account in New York, and credited to the special funds account, are to become the property of the Bank of Mexico and the government of Mexico. With respect to all exports that are not excluded under the agreements, PEMEX is to irrevocably

¹²This example assumes (1) a maturity for Mexican debt securities of 10 years, principal repayment at the end of 10 years, and interest repayment annually; (2) an interest rate on the debt securities of 6.5 percent per year, comprised of Treasury's cost of borrowing of 6.0 percent, plus a liquidity premium of 50 basis points to reflect the fact that these securities would be less liquid than U.S. Treasury bonds; and (3) a credit risk premium of 375 basis points, assuming that, with the \$8 billion guarantee, Mexico will have more than \$15 billion outstanding under the program.

instruct its existing customers, and is required to instruct new customers, to make all payments to the account of PEMEX at the New York branch of a major international bank. PEMEX is to instruct the New York branch of a major international bank to transfer all payments to the Federal Reserve Bank of New York special funds account within 1 business day of receipt.

The Bank of Mexico is to authorize the Federal Reserve Bank of New York to use the funds in the special funds account to repay all amounts due and payable under the assistance agreements. Amounts may be withdrawn by the Bank of Mexico when there are no amounts due and unpaid. The Bank of Mexico and the government of Mexico are to authorize the Federal Reserve Bank of New York to debit any account, to liquidate investments, and to transfer all proceeds to a Treasury account in the event that the Federal Reserve Bank of New York receives a notice from Treasury that Mexico has failed to make any payment under the assistance agreements. The oil agreement also requires that PEMEX not export Mexican crude oil or oil derivatives other than through a PEMEX entity and that PEMEX must cause any of its subsidiaries that export crude oil or oil derivatives in the future to become a party to the oil agreement. Finally, PEMEX is required to maintain adequate insurance for all its businesses and properties.

The oil agreement requires PEMEX to furnish Treasury with copies of Securities and Exchange Commission reports, notices of default, quarterly statements, and projections of crude oil and oil derivatives exports, and whatever additional information that the Treasury determines to be reasonably necessary. Furthermore, Mexico agreed to notify and consult with Treasury in the event that, during any 12-month period ending at the end of any calendar quarter, the volume of crude oil exports is less than 85 percent and the dollar value of the total amount of crude oil exports and oil derivatives exports is less than 80 percent of the corresponding period in 1994. After 5 years, these threshold levels are to be 75 percent and 75 percent, respectively. The purpose of the consultation is to assure Treasury that Mexico continues to have the means to repay its loan obligations from PEMEX oil and oil derivative export revenues should that become necessary. If Treasury is not assured, Treasury and the Mexican government need to agree on new terms that provide such assurance. If Mexico and Treasury do not reach agreement after consultation, Treasury can enforce mandatory prepayment provisions.

Conditions Placed on
Mexico

The agreements placed several financial and economic conditions on Mexico. The agreements provide that no funds may be made available to

Mexico unless Treasury determines that the resources of Mexico, including oil proceeds, are adequate to assure repayment. To make this determination, Treasury may require Mexico to provide confirmation by independent public accountants that information in quarterly reports as to export proceeds is consistent with the books and records of PEMEX and its subsidiaries. Furthermore, the framework agreement requires Mexico to provide to Treasury its financial plan, and at least annual updates of the plan, during the time that ESF resources are available. Before each request for funding, Mexico must submit to Treasury a written description of Mexico's financial developments, the intended use(s) of the proposed funds, and how such use(s) are consistent with the financial plan. No funds may be provided if Treasury determines that Mexico or the Bank of Mexico has taken actions that are materially inconsistent with the financial plan, the financial plan is materially inconsistent with prevailing conditions, the intended use(s) are inconsistent with the financial plan, or Treasury does not concur with any material changes by Mexico to its financial plan.

Certain economic policy conditions also apply. For example, the framework agreement provides that no funds will be provided if the Treasury determines that Mexico and the Bank of Mexico's economic policies are not in accordance with those economic policies approved by IMF as part of its assistance program or if Mexico fails to implement any of the economic policies announced by Mexico at the time the agreements were signed.

Acceleration of Payments

Under the agreements, Treasury may demand payment of any or all of the swap obligations of Mexico, and require the defeasance¹³ or redemption of the guaranteed debt securities that are subject to redemption, if Treasury determines that Mexico has failed to comply with certain terms of the assistance agreements. However, certain notice and grace periods apply to specified events of noncompliance. For example, Mexico has 7 days to remedy the nonpayment of principal or interest. If all amounts due are paid and all defaults are remedied, Treasury may rescind its demand or requirement. In the event of an acceleration of payments, early redemption of guaranteed debt securities, or defeasance, the Treasury may distribute the funds received as it deems appropriate.

¹³In general, "defeasance," as contemplated by the guarantee agreement, would involve the irrevocable deposit by the Mexican government with the fiscal agent, in trust, or with Treasury or the Federal Reserve Bank of New York, in trust, of government securities or cash which, together with the earnings thereon, would be sufficient to pay principal and interest of the guaranteed debt securities when due.

Optional and Mandatory Prepayment

Mexico may, at any time, prepay any or all of its obligations under the assistance agreements. Treasury may require Mexico to prepay its swap obligations, defease the guaranteed debt securities, or redeem debt securities upon its determination that Mexico has "well-established access to funds on reasonable market terms." Mexico is to provide to Treasury all the information that Treasury reasonably requests to make its determinations.

Analysis of Terms and Conditions

Our Analysis of Rates and Fees

In justifying the U.S. support package, Treasury officials stated that the United States would be sufficiently compensated for any risk associated with the financial assistance provided Mexico. The specific interest rates applied to the short-term swaps are intended to cover the cost of funds to Treasury and therefore are set at the inception of each swap transaction based on the then current 91-day U.S. Treasury bill interest rate. This is the same rate that the Federal Reserve and Treasury charge other countries for short-term currency swaps. As of August 1, 1995, the annual rate, adjusted quarterly, for short-term swaps was 5.45 percent.

Mexico is to be charged a higher interest rate for medium-term assistance at least sufficient to cover the U.S. government's assessment of its credit rating. Interest charges, which are determined at the time of disbursement on the medium-term swaps, are designed to cover the costs of funds to Treasury plus a premium for the risk associated with the extension of funds. For each medium-term swap disbursement, the premium is to be the greater of (1) a rate determined by the U.S. government's ICRAS to be adequate compensation for the sovereign risk of Mexico or (2) a rate based on the amount of U.S. funds outstanding to Mexico from short- and medium-term swaps and securities guarantees at the time of disbursement, which rate is between 225 basis points (if \$5 billion or less is outstanding) and 375 basis points (if \$15 billion or more is outstanding). The rates for medium-term swaps were 7.8 percent for funds disbursed in March 1995, 10.16 percent for funds disbursed in April and May, and 9.2 percent for funds disbursed in July.

A senior Treasury official told us that for two reasons the actual risk to the United States may be less than the ICRAS premium. First, the oil proceeds

facility allows the United States to take proceeds from the sale of exported PEMEX oil if Mexico defaults. According to the official, the oil proceeds facility provides a strong incentive for Mexican officials to take actions to avoid a default, since it would be a politically sensitive issue if a point were reached where the United States could start taking proceeds passing through the facility. The official further noted that there has been a history of successful loans to Mexico that made use of oil proceeds facility arrangements. Second, in the official's analytical judgment there is a reasonable expectation that Mexico's economic package will be successful. This is important because a successful economic program is needed if Mexico is to be capable of repaying the loans.

In circumstances such as the Mexican financial crisis, in which financial markets essentially ceased to function in terms of Mexico's access,¹⁴ markets cannot be relied on to provide an accurate measure of the risk. We believe that the use of the ICRAS rate as a starting point, followed by adjustments, was a reasonable approach to determine risk premiums.

Our Analysis of the Oil Agreement

The oil agreement has been executed to help ensure that if Mexico defaults on its obligations, the United States will be repaid both principal and interest from oil export proceeds that PEMEX earns. Proceeds from PEMEX's sale of oil to customers are to be deposited into an account at the New York branch of a large international bank and transferred to a special account at the Federal Reserve Bank of New York under the terms of an irrevocable, acknowledged instruction. The Federal Reserve Bank of New York, acting on behalf of Treasury, has a right of set-off against these deposits if Mexico fails to make interest and principal payments to the United States under the swaps or the United States makes a guarantee payment. In Treasury's view, the oil proceeds payment mechanism, while not ironclad, does provide the United States with a high degree of repayment assurance and represents an improvement over oil export facilities that had been provided as assured sources of repayment for previous swaps with Mexico.

An oil agreement has been an integral part of previous U.S. financial assistance packages for Mexico. The United States has never had to draw on oil proceeds in five previous agreements. For each of these agreements, Mexico fully repaid all principal and interest due. Treasury officials told us that the current oil agreement is an improvement over previous oil

¹⁴According to Bank of Mexico data, for three successive weekly auctions between December 27, 1994, and January 10, 1995, the number of bids fell far short of the amount of tesobonos offered at auctions for all maturities.

agreements in that the agreement, among other things, requires the flow of oil payments proceeds through the account at the outset of the agreement;¹⁵ allows Treasury to require mandatory prepayment of U.S. loans if export volumes and proceeds fall significantly below 1994 levels; includes irrevocable payment instructions acknowledged by PEMEX customers; includes oil derivatives; and includes PEMEX's exporting subsidiaries.

Another Treasury official told us that it would be difficult for PEMEX to circumvent the oil proceeds facility. For example, he said it would be difficult for PEMEX to order its customers to send their oil payments elsewhere if the United States called for accelerated prepayment.

According to the official, PEMEX customers sent legal notices to the Federal Reserve Bank of New York acknowledging the irrevocable nature of the PEMEX deposit instructions. Thus, he said, there would be legal barriers to the customers not doing what they had agreed to do. If PEMEX were to cut off the customers who had agreed to deposit their payments in the facility and instead sold the oil on the spot market without having those proceeds transferred to the Federal Reserve Bank of New York account, PEMEX would be in violation of the oil agreement. This he said, would be a major blow to U.S.-Mexico relations. Also, doing this would risk ruining PEMEX's existing relationships with regular customers, and PEMEX had gone to great trouble to create these relationships.

Finally, Treasury officials have pointed out that the coverage provided by the funds flowing through the account over time is far greater than Mexico's outstanding obligations under the agreements. Treasury's assessment is based on 1995 oil export revenues (estimated at \$8 billion), market expectations of future export revenues, and conservative U.S. interagency projections for future Mexican oil and oil derivative export revenues. In addition, Treasury officials noted that the oil export threshold mechanism as described above provides an extra measure of protection against rapid changes in oil prices or export volumes. In Treasury's view, while such changes may affect the time needed to pay off outstanding obligations, Treasury would be compensated through the application of late charges.

Whether the oil proceeds payment mechanism provides a high degree of repayment assurance is difficult to assess because the facility depends on future payments. The oil agreement amounts more to a call on future payment flows rather than collateral in the traditional legal sense. The oil

¹⁵In the previous agreements, funds did not flow into the account unless Mexico defaulted.

agreement does not require a minimum balance and, absent a default, proceeds are to regularly flow to an account of the Bank of Mexico. The United States can stop disbursement of additional loan payments to Mexico or can demand prepayment if Mexico stops paying on its loans. Since the initiation of the agreement, Treasury reports show that for each business day, approximately \$25 million to \$30 million has flowed into the account. Treasury officials told us that about \$6.8 billion flowed through the account as of December 29, 1995. Under the terms of the agreement, money may be transferred out of the account several times each day at the request of the Bank of Mexico, and at most, a single day of proceeds is likely to be in the account. Consequently, funds on deposit would not be sufficient to cover a major nonpayment by Mexico. However, the account could be used over time to pay off a default provided that PEMEX continued to produce and export oil to the customers covered by the agreement. Changes in the world price of crude oil and petroleum products could affect the size of the deposits made and thus the time that would be needed to pay off any major nonpayment. Because of these uncertainties, in our view, the oil agreement by itself cannot be considered as providing a high degree of assurance that the United States will be repaid if Mexico defaults on its loans or guarantees, but considered in the context of the agreements implementing the assistance package, it does enhance the likelihood of repayment.

**Other Terms of the
Agreements Increase the
Likelihood of Repayment**

In assessing the value of the oil agreement and the likelihood of repayment by Mexico, the other terms and conditions of the framework agreement must be considered. Under the framework agreement, Mexico is to take actions to increase the likelihood that the United States will be repaid for the swaps and securities guarantees. In the framework agreement, Mexico agreed to meet stringent economic and monetary policy conditions in return for U.S. and IMF assistance. These economic conditions provide the United States and IMF with a degree of influence over Mexican economic policy that did not exist before the onset of the financial crisis in December 1994. The agreements are to ensure that the U.S. and IMF will not lend if economic and monetary targets are not being met, that the United States can call for prepayment in certain cases of policy failure, and that the United States will be alerted to policy changes. For example, as a result of the stringent conditions and other factors¹⁶, Mexico's trade balance was transformed from a large deficit into a surplus during the first

¹⁶Other factors responsible for the trade balance reversal include real depreciation, reduction in spending due to balance sheet problems, and reduced access to international credit.

6 months after the framework agreement was signed. This rapid turnabout has positive implications for Mexico's ability to meet its debts.

The framework agreement also allows Treasury substantial discretion in determining compliance by the government of Mexico. For example, Treasury can determine whether Mexico has adequate resources to assure repayment of funds drawn and whether Mexico has implemented economic policies consistent with IMF's program. Furthermore, Treasury may require Mexico to prepay, defease, or redeem its obligations upon Treasury's determination that Mexico has well-established access to funds on reasonable market terms. These broad provisions require close monitoring, frequent consultation, and timely information-sharing between Treasury and Mexico.

The Secretary of the Treasury and other U.S. government officials have acknowledged a negative aspect of the package, in that it entails government intervention in the functioning of financial markets. They have concluded, however, that the risks associated with not acting on behalf of Mexico would have been greater than those associated with the assistance package, given the interdependence of the Mexican and U.S. economies and the possible adverse impacts of the Mexican crisis on international financial markets generally. Also, no orderly work-out solution appeared feasible because of the difficulty of working with many creditors.

IMF Assistance Package

The second largest component of the assistance package for Mexico comes from IMF. IMF assistance was designed to restructure Mexican debt and was contingent upon several things, including Mexico's reducing its current account deficit and its inflation rate. On February 1, 1995, IMF announced an 18-month standby credit of \$17.8 billion for Mexico.¹⁷ IMF made \$7.8 billion available immediately after the announcement. IMF agreed to provide the remaining \$10 billion to the extent that a proposed package from a group of unspecified non-G-10 countries falls short of its \$10-billion target. In this event, the remaining \$10 billion in IMF resources would be made available to be drawn through mid-1996. According to an IMF official, repayment of funds under the IMF assistance package must be made within 3 to 5 years.

¹⁷IMF actually approved assistance for Mexico for up to special drawing rights (SDR) 12.07 billion. SDR is a unit of account IMF uses to denominate all its transactions. Its value comprises a weighted average of the value of a basket of five currencies, of which the U.S. dollar has the largest share.

An IMF official told us that this is the largest loan standby arrangement IMF has ever extended to one country, and the largest standby arrangement that IMF has ever extended as a percentage of a country's IMF quota, the subscription that member countries pay to IMF. Current rules permit an IMF member to borrow an amount equal to 100 percent of its quota per year, with a cumulative limit of 300 percent, unless exceptional circumstances exist. Mexico's IMF quota is about \$2.6 billion. IMF's current potential lending to Mexico under the assistance package is equivalent to about 688 percent of its quota over an 18-month period, or 459 percent of its quota on an annual basis. This is substantially higher than the limit of 100 percent of quota on an annual basis, which is the usual maximum.

According to an IMF official, Mexico had no outstanding borrowing arrangements in place with IMF at the end of January 1995. Its last credit facility was negotiated in May 1989. Drawings under that agreement were completed on May 25, 1993. At the time of the current Mexican crisis, Mexico still owed about \$3.8 billion from the 1989 IMF loan arrangement but was fully up to date in its repayments.¹⁸

Terms and Conditions of IMF Assistance Package

IMF approved an 18-month standby credit arrangement for Mexico of up to \$17.8 billion. Of the total, about \$7.8 billion was made available immediately. The remaining \$10 billion is to be provided by IMF to the extent that Mexico seeks to draw more than the initial \$7.8 billion and to the extent that contributions of governments and central banks fall short of the targeted amount of \$10 billion. The IMF standby credit arrangement is intended to complement other external financing for Mexico.

An IMF official provided information on both the availability of and repayment schedule for drawings under the IMF's standby credit arrangement for Mexico. Repayments are to begin 3 years after the date of each drawing, and repayment of each drawing is to be made in eight equal quarterly installments. Therefore, each drawing is to be paid in full after 5 years, and the standby credit arrangement is to be paid in full 5 years after the date of the last drawing.

The IMF assistance package imposes a variety of economic policy performance criteria on Mexico as conditions of lending. Some of these

¹⁸IMF borrowing arrangements are considered completed upon the final drawing of resources by the borrowing country under the agreement. The borrowing country typically begins repayment installments before the last drawing and continues to make payments on the remaining amount due after that time. Thus, payments can still be due even though an IMF arrangement is considered completed.

criteria, such as foreign exchange reserves and domestic credit expansion, are strictly quantified with quarterly review dates; if these quarterly targets are met, IMF will continue to make funds available to Mexico. Other measures, such as privatization revenues, have "goals" or benchmarks with greater flexibility.

According to the IMF official we interviewed, IMF does not generally specify "events of default" in its agreements with borrowers. IMF's usual practice is to make "policy judgments" regarding potential defaults. An IMF director may ask for IMF executive board review of a borrower's situation if loan conditions are not being met. If a borrowing country is slightly "off track," IMF may grant a waiver of certain loan conditions. If a borrowing country is severely "off track," IMF stops new lending and negotiates corrective policy actions to bring the borrower back "on track." The borrower's economic program is to be revised or restructured with IMF executive board approval.

In September 1995, an IMF official said that there have been no problems between IMF and Mexico, which he said seems to be ahead of its agreed-upon economic program. Although Mexico may not need additional IMF funds, it still has the right to draw under the standby credit agreement.

We believe that the IMF package is especially important because IMF is generally considered the lender of last resort to sovereign countries. If Mexico fails to meet the terms and conditions of its agreement with IMF, Mexico could find it especially difficult to borrow from other lenders. Thus, Mexico has a strong incentive to comply with the terms and conditions of the IMF agreement. Doing so should increase the likelihood that the United States will be repaid for the financial assistance it has provided to Mexico.

Interest Rates and Fees in the IMF Assistance Package

An IMF official explained that the IMF assistance package to Mexico is priced at an "SDR interest rate" that is a weighted average of interest rates on short-term (3-month) government securities of the Group of Five countries (France, Germany, Japan, the United Kingdom, and the United States). The weighting corresponds to the weighting of the currencies of these countries in the SDR. The SDR interest rate is adjusted quarterly and is applied to all drawings under the standby facility. The SDR interest rate was about 5 percent per year as of July 1995.

No liquidity or maturity premium, and no country-specific risk premium, are added to the basic SDR interest rate. However, certain adjustments are made to the basic SDR interest rate to cover IMF's administrative costs, to account for "free reserves" (i.e., contributed capital and retained earnings), and to accumulate reserves for problem credits. According to the IMF official, the net effect of these adjustments makes the rate charged to borrowers virtually equal to the basic SDR interest rate and somewhat higher than IMF's average cost of funds.

IMF is charging Mexico a commitment fee of 0.25 percent on the total commitment of \$17.8 billion, less amounts drawn. This annual fee is payable at the beginning of each year. IMF is also charging Mexico a usage fee of 0.5 percent on the amount of each drawing. This fee is payable at the time of each drawing. The IMF official said that these fees, in addition to the other IMF terms and conditions, provide incentives to Mexico to return to the private capital markets as soon as possible.

IMF Collateral and Creditor Status

An IMF official confirmed that IMF's assistance package to Mexico requires no collateral or security interests; however, he said that, in IMF's view, "The policy conditions provide collateral." IMF typically lends on an unsecured basis because borrowing countries generally have no collateral when they come to IMF for assistance.

The IMF official said that IMF's preferred creditor status is not a legal right or condition, but rather an international convention and generally accepted practice. IMF, for example, does not reschedule its loans when a borrowing country restructures its other public and private debt. This practice reflects its de facto preferred creditor status.

According to the IMF official, no documents specify that IMF has a preferred creditor status and, for example, the U.S. assistance agreements with Mexico do not explicitly recognize IMF's preferred creditor status. Furthermore, he stated that some IMF officials expressed concern about the oil agreement between the United States and Mexico, since IMF was lending Mexico 459 percent of its quota. They believed that the United States would have a prior claim on a significant portion of Mexico's cash flow in any future crisis situation.

Other Information on the IMF Assistance Package

Some observers have commented that Mexico might not need to draw further on IMF's assistance package if it can borrow on better terms

elsewhere. An IMF official responded that the comment probably did not refer to the IMF's interest rates and fees, which are lower than the current rates for Mexico in the private capital markets, but rather to other terms and policy conditions.

The IMF official said that IMF has a distinct philosophical approach to its assistance lending, i.e., "it works with countries when the markets have failed them." IMF does not attempt to compete with private capital markets, but rather to provide support to stabilize economic and financial conditions in countries and markets. This approach reflects the basic purpose of IMF since its inception and applies in the case of Mexico. The IMF official noted that the U.S. government or other international organizations may have different purposes in providing assistance to Mexico.

Mexico's Economic Plan

After the international assistance package for Mexico was announced, on March 9, 1995, the government of Mexico released a new economic plan to address the economic crisis. The plan contains stringent economic policy adjustments consistent with agreements reached with the United States and IMF. Its goals, as stated by the Finance ministry, are to restore financial stability, strengthen public finances and the banking sector, regain confidence, and reinforce the groundwork for long-term sustainable growth. Officials from the Finance ministry told us that they recognized that the plan would result in an economic shock for the country more severe than had been anticipated in the initial Mexican response of early January. The hardship includes high interest rates, negative economic growth, high unemployment, and a significantly higher inflation rate. The Finance ministry officials stressed that the government expected this pain to be short-lived, as Mexico makes the economic adjustments necessitated by the economic crisis and incorporated in the March 9 plan.

Conclusions

Under the terms of the U.S. assistance package, Treasury committed ESF to a \$20 billion facility composed of three mechanisms. The Secretary of the Treasury concluded that the assistance package was consistent with the IMF obligations of the United States on orderly exchange rates and a stable exchange rate system. We concur with legal advice that the Treasury Secretary secured that he had the requisite authority to use ESF to provide such assistance to Mexico. As of December 22, 1995, \$13.5 billion had been disbursed, while \$11.8 billion remained outstanding.

Interest rates applied to short-term swaps are intended to cover the cost of funds to Treasury and are based on the current 91-day U.S. Treasury bill interest rate. Interest charges for medium-term swaps are designed to cover the costs of funds to Treasury plus a premium at least sufficient to cover the risk associated with the extension of funds over a longer period. Medium-term funds disbursed in April and May carried an interest rate of 10.16 percent, which included a risk premium of 3.52 percent when compared to the average of market bid quotations on actively traded 5-year Treasury securities (i.e., 6.64 percent) during those 2 months.

The risk of nonpayment to the United States is further mitigated by the oil proceeds facility, Mexico's agreement with both the United States and IMF to achieve stringent economic policy conditions, and the IMF's assistance package itself. Whether the oil proceeds facility provides a high degree of repayment assurance is difficult to assess because the facility depends on future payments. However, the facility may provide an important incentive for Mexican leaders to take actions to avoid a default, since it would be a politically sensitive issue in Mexico if a point were reached where the United States could start claiming proceeds moving through the facility. Also, it could be difficult for Mexico to circumvent the facility because PEMEX customers have acknowledged the irrevocable nature of PEMEX deposit instructions, and PEMEX might be reluctant to jeopardize established relationships with existing customers.

Initial Impact of Mexico's Financial Crisis and Efforts to Recover, Including the International Assistance Package

Despite suffering a traumatic economic crisis in 1995, Mexico has shown signs of recovery, with financial assistance from the United States and the International Monetary Fund (IMF). Mexico is using international funds to help in its efforts to stabilize its economy. Although the country was still in the midst of a severe recession in August 1995, it showed some positive economic indicators. Notably, the current account deficit for the first half of 1995 was reduced by 96 percent compared to the same period in 1994. In addition, Mexico has begun to access international capital markets, with the successful offering of several large bond issues during the summer and fall—an indication that investor confidence may be returning to Mexico. Nevertheless, the precarious state of the Mexican banking system, which the government has taken a number of steps to bolster, remains a concern. Despite the progress to date, Mexico still faces many difficult challenges before its financial crisis can be resolved.

Mexico's Initial Actions in Response to the Economic Crisis

In January 1995, the government of Mexico began to take action to deal with the financial crisis. In response to the continued pressure placed on the Mexican peso after its December 1994 devaluation, the government of Mexico announced a change in its economic policies on January 3 with the introduction of a new emergency economic agreement. An extension of earlier Pactos, the agreement had objectives that included avoiding an inflationary spiral caused by the devaluation and reestablishing investor confidence to stabilize access to financial markets. The government acknowledged that the devaluation would result in painful consequences for the country, including a temporary inflationary spike, a drop in real earnings, the postponement of important public spending projects, and a temporary credit squeeze.

The Mexican government was not able to achieve the agreement's goal of regaining stability in the financial markets, however. Some of the government's economic projections incorporated in the agreement, such as maintaining a current account deficit of \$14 billion and reducing the expected rate of GDP growth from 4 percent to 1.5 to 2 percent for 1995, were not viewed as credible by international investors. As a result, the government plan did not stem the tide of foreign investors leaving the Mexican market.

Mexico's Economic Plan

On January 3, 1995, the government of Mexico; the Bank of Mexico; and representatives of labor, farm, and business sectors signed the Agreement of Unity to Overcome the Economic Emergency. This economic austerity

program was presented to IMF in Mexico's request for a standby arrangement. In approving the standby arrangement, IMF endorsed the Mexican government's austerity program.

Mexican officials determined that the January economic package was not successful, however, because foreign investors continued to withdraw funds from Mexico. On March 9, 1995, Mexico's Finance ministry announced a new package of monetary, fiscal, banking, and social measures that sought to restore financial stability, strengthen public finances, assist the banking sector, regain confidence, and reinforce the foundations for long-term sustainable growth. The plan contains stringent economic policy adjustments consistent with agreements reached with the United States and IMF. The principal goals of Mexico's program, as stated by the Finance ministry, were the containment of inflation and the reduction of the current account deficit. However, the March economic plan was not initially accompanied by a Pacto between the Mexican government, business, and labor.

Officials from the Finance ministry told us that they recognized that the plan would result in an economic shock for the country more severe than had been anticipated in the initial Mexican response of early January. The economic hardship to date has included high interest rates, negative economic growth, high unemployment, and a significantly higher inflation rate. One Finance ministry official stressed that the government expected this pain to be short-lived, as Mexico made the economic adjustments necessitated by the economic crisis and incorporated in the March 9 plan. Elements of the plan are as follows.

Monetary Policy

The March 9 plan stated that through its new monetary policy, Mexico would attempt to focus on stabilizing the exchange market. As a result, domestic credit would be severely curtailed through tightened monetary policy and increased financial regulation on the part of the Bank of Mexico. The Mexican money supply would be cut 20 percent in real terms.¹

¹According to the Federal Reserve, Mexico's monetary program is intended to target a particular growth rate of net domestic assets, which, given flat net international reserves, would produce a particular growth rate of the nominal monetary base. The extent of real reduction in the monetary base then depends on inflation.

The Bank of Mexico also established new reserve requirements as well as limits on bank overdrafts, as a result of the plan.²

Exchange Rate Policy

The floating exchange rate policy would be continued. The March plan projected that the exchange rate would be 6-6.5 pesos to the dollar through 1995. The government planned to avoid any measures that would limit currency convertibility. To facilitate the reduction of risk in exchange market transactions and allow hedging against peso/dollar fluctuations, (1) qualified domestic banks were to be authorized to conduct futures transactions in pesos with customers and on an interbank basis and (2) a parallel futures market at the Mexican Stock Exchange and the Chicago Mercantile Exchange was to be initiated.

Fiscal Policy

The IMF program called for the Mexican government to continue to strengthen its public finances. Selected fiscal policy measures were stipulated as follows:

- The value-added tax rate was to be increased from 10 percent to 15 percent.
- Budgetary outlays were to be reduced by 1.6 percent of GDP for fiscal year 1995.
- Taxes on gasoline and diesel fuel were to be increased by 48.5 percent and electricity prices increased by 20 percent immediately and 0.8 percent per month for the rest of 1995.
- The fiscal surplus was to be increased by 2.1 percent of GDP.

Banking Policy

Measures to deal with the banking crisis were also announced on March 9, 1995. The International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, and other sources agreed to provide resources of up to \$3 billion to strengthen Mexico's commercial banks. To ease growing domestic debt burdens under Mexico's high inflation rates, financial authorities and the Mexican Bankers Association put into place a loan restructuring program with inflation-indexed units of account for small- and medium-sized firms. In addition, Mexico's deposit protection agency provided temporary capital to banks with short-term capital needs.

²According to the Federal Reserve, there is still no reserve requirement on bank deposits. The Bank of Mexico has replaced a system in which overdrafts had to be cleared on a daily basis with a system in which commercial banks are required to hold a zero cumulative reserve position with the Bank over a month-long period.

Incomes and Social Policy

Mexico also made changes in incomes and social policy. Mexico increased the minimum wage by 10 percent, in addition to a previously announced 7-percent increase in wages. Because the two increases were well below the projected inflation rate of 42 percent, the March 9 plan projected that there would be a decline in real wages. Health benefits for unemployed workers were extended from 2 to 6 months, and a rural employment program was instituted.

Improved Transparency

The plan also included a promise by Mexico that information on foreign currency reserves and domestic credit conditions would be announced on a weekly basis.

Initial Economic Indicators Showed Promise for Mexico Despite Continuing Hardship

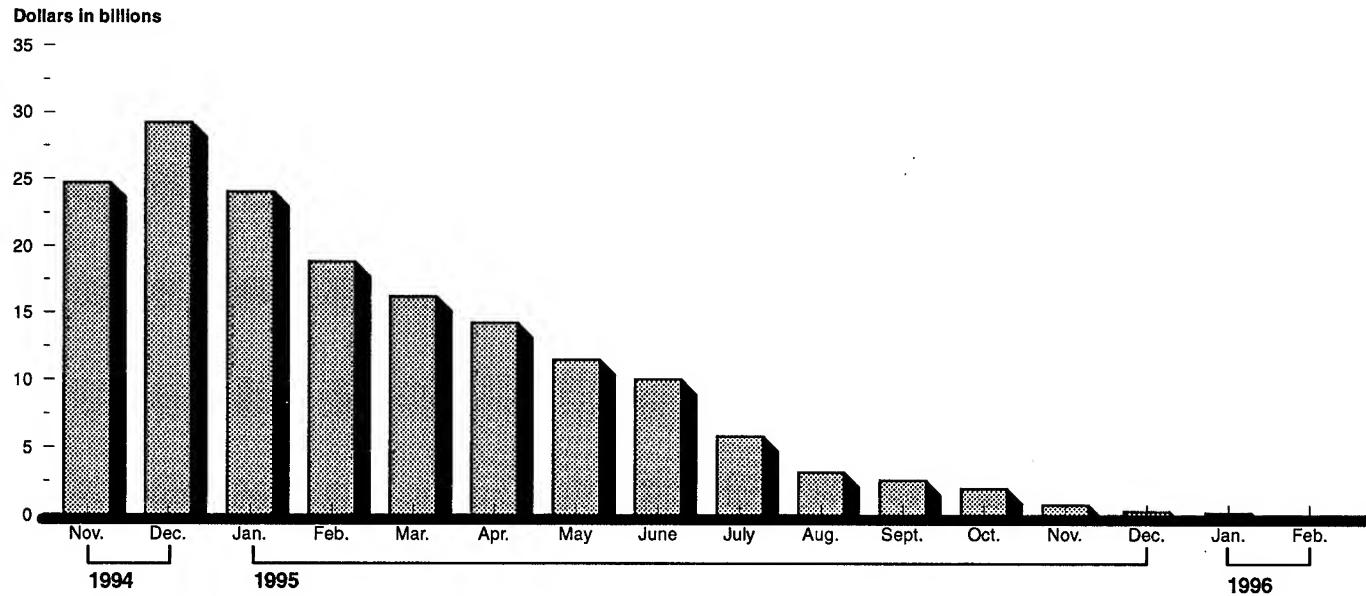
The government of Mexico has drawn on the international assistance offered by both the United States and IMF. According to the Treasury December report, as of December 22, 1995, \$13.5 billion in U.S. funds had been disbursed to Mexico under the U.S. assistance program. Of this amount, \$11.8 billion remained outstanding: \$1.3 billion in short-term swaps and \$10.5 billion in medium-term swaps. As of December 31, the United States had not extended any securities guarantees to Mexico. Through the end of 1995, Mexico had not missed any interest payments or required principal repayments under any of the swaps. As of December 31, ESF had received \$447.4 million in interest payments from Mexico for short-and medium-term swaps, and the Federal Reserve had received \$46 million in interest on its short-term swaps with Mexico. On January 2, 1996, \$242.4 million in interest was due to Treasury on the medium-term swaps; a Treasury official confirmed that that interest payment had been received. In early October, Mexico prepaid \$700 million of the \$2 billion in swaps coming due October 30, anticipating the proceeds from a German mark-denominated bond issue. Mexico had also drawn \$13 billion from IMF by the end of December 1995, none of which had fallen due or been repaid.

In the first 3 quarters of 1995, Mexico had exhibited some positive economic indicators that suggested the government's economic strategy was meeting its initial objectives. The government's strategy relies on a combination of unilateral economic adjustments combined with policies that have been mutually agreed upon between the government and IMF. As such, it is difficult to evaluate the direct effect of the international assistance package on the Mexican economy. Nevertheless, some of the initial indicators showed promise for reaching the government's objectives. For example,

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- during the first half of 1995 the current account deficit was \$620 million, a reduction of 96 percent in comparison with same period in 1994 when the current account deficit was \$13.8 billion;
- at the end of August, the peso was trading at 6.3 to the dollar, about 20 percent above the March 9 low of 7.45 to the dollar;
- foreign currency reserves grew to \$13.4 billion by August 18, up from a low of less than \$4 billion in January, based in part on the capital flows from the international assistance package;
- interest rates on short-term government securities (cetes) came down from peak of 83 percent in March to 34 percent in August;
- the inflation rate declined from a peak of 8 percent for the month of April to 1.7 percent for August; and
- 90 percent of tesobonos outstanding at the end of 1994 were retired by the government by the end of August 1995. (See fig. 5.1.)

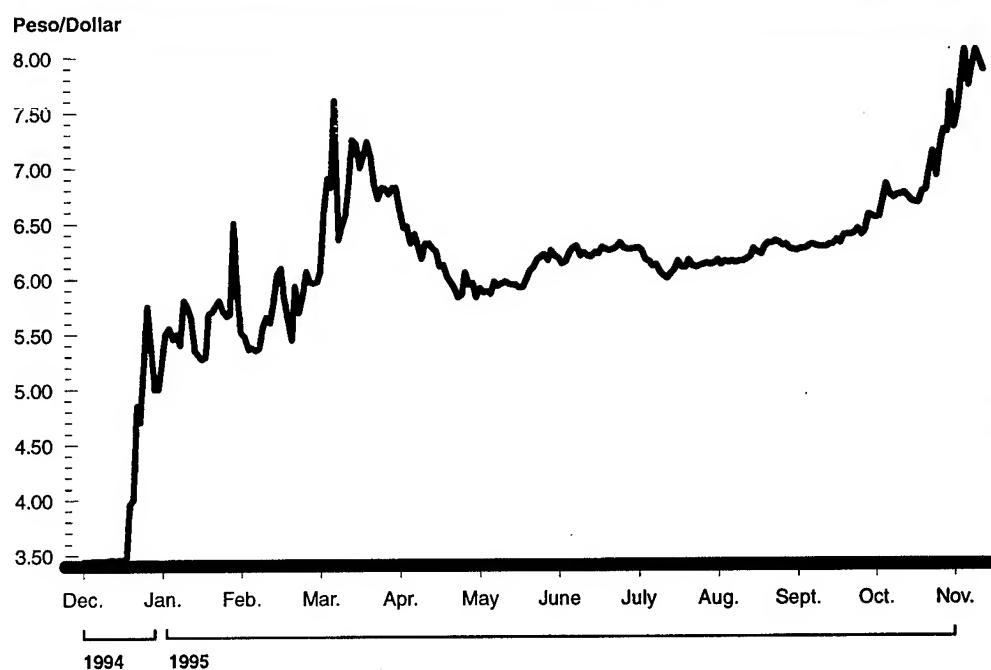
Figure 5.1: Outstanding Tesobonos, November 1994 - February 1996



Source: Government of Mexico.

However, more recent indicators demonstrate the difficulty Mexico faces in making its economic adjustments. For example, Mexico's GDP for the third quarter of 1995 was 9.6 percent lower than the third quarter of 1994, indicating a deeper recession than the official Mexican government forecast of 2-percent negative growth for 1995. In addition, the value of the peso slid against the dollar in October and November, closing at a low of 8.14 to the dollar on November 9, 1995. The peso has since regained some value, closing December 8, 1995, at 7.75 to the dollar. In response to peso volatility, the government tightened credit, and interest rates on cetes rose to as high as 60 percent in mid-November. Rates fell to 49.1 percent in the December 18, 1995, auction. (See fig. 5.2).

Figure 5.2: Peso/Dollar Exchange Rate,
December 1, 1994 - November 16, 1995



Source: Federal Reserve Board.

Finance ministry officials told us that at the end of 1994, the Mexican people had very positive expectations about their future, so that when the

economic crisis hit, many were shocked and felt deceived. Many did not understand why, after so much reform had taken place, they would again have to face such hardship.

The government of Mexico has responded to the impact of the crisis by taking measures such as allowing the minimum wage to increase and raising producers' subsidies for bread, tortillas, and milk. In addition, Finance ministry officials told us that the government plans to implement programs to assist in worker training and to provide rural relief. Nevertheless, real spending on social services such as education, health, and potable water projects has declined, according to a U.S. Treasury report.³

Mexico's middle class, which had greatly benefited from Mexico's recent economic reforms, has also been seriously affected by the devaluation, in large part due to its accumulation of debt that is either dollar denominated or that has floating interest rates, according to U.S. embassy officials. A number of debtor relief organizations have sprung up, putting pressure on the government to respond. At the end of August, the government of Mexico announced a new program to provide some relief to Mexican borrowers. The Debtor's Aid Agreement set ceiling interest rates for debtors carrying relatively low outstanding balances on their loans. For example, credit card holders will pay 38.5 percent on the first \$800 dollars they owe, with market interest rates applying to balances higher than that level. Similarly, limits were also established for corporate and personal loans. Borrowers who have been keeping up with their payments are automatically eligible for the program, while others are to have a grace period to renegotiate their loans.

Initial Financial Indicators Were Positive

The cornerstone of Mexico's economic recovery may well be Mexico's ability to reestablish the confidence of international investors. In particular, Mexico must be able to reenter world capital markets to help finance Mexico's recovery. Several financial indicators to date suggest that investor confidence may be improving.

³The report notes that real spending for these categories has declined less than for other government discretionary programs. See Secretary of the Treasury, Monthly Report Pursuant to the Mexican Debt Disclosure Act of 1995, (Washington, D.C.: June 30, 1995.)

Mexico Has Started to Regain Access to International Capital Markets

Mexico has been able to return to the international capital markets to restructure its short-term debt into longer-term obligations, a positive sign that the government's strategy for financial recovery may be accepted by international investors. On April 24, one of Mexico's government development banks, Nafinsa, reentered the capital markets by borrowing \$170 million from a European bank at an interest rate equal to the London Interbank Offered Rate (LIBOR)⁴ plus 600 basis points, according to Nafinsa officials. They explained that this was an important gesture because it showed that Mexico was back in the market, and it might create some momentum. Both Nafinsa and Bancomext, another Mexican development bank, have since been able to access international capital markets.

The next significant step in returning to the international capital markets for Mexico was the issuance of medium-term sovereign debt by the government in July. The government of Mexico offered \$500 million in floating rate, dollar-denominated notes with 2-year maturities. The offering was oversubscribed, and the issued amount was increased to \$1 billion. The offering was led by Citibank, Credit Suisse, and the Bank of Tokyo and the principal and accrued interest of these notes may be converted into new capital in a newly formed or existing Mexican bank or tendered as payment for shares in any Mexican privatization. In August, Mexico did a second international offering of 3-year, yen-denominated notes with a face value of about \$1.1 billion. (See table 5.1).

Table 5.1: Mexican Public Sector Bond Issuances, May-November 1995

Issuer	Type	Issue date	Amount (U.S.\$M)	Maturity	Interest rate
Bancomext	Euro FRN	May 23	\$30.0	1 year	LIBOR + 5.80%
	Euro FRN	May 31	\$75.0	1 year	LIBOR + 5.44%
	Euro FRN 144A ^a	June 23	\$300.0	2 years	LIBOR + 5.51%
	Eurobond	Oct. 2	¥20 billion (approx. \$200.0)	2 years	3% coupon
Nafinsa	Euro FRN	May 4	\$110.3	1 year	LIBOR + 3.50%
	Euro FRN	May 4	\$73.7	7 months	LIBOR + 2.25%
	Euro FRN	May 9	\$50.0	1 year	LIBOR + 6.00%

(continued)

^aLIBOR is a key interest rate at which major banks in London are willing to lend to each other. It is often used as a benchmark rate in international financial transactions.

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Issuer	Type	Issue date	Amount (U.S.\$M)	Maturity	Interest rate
	Euro FRN	May 15	\$28.0	1 year	LIBOR + 8.00%
	Euro FRN	May 24	\$10.0	1 year	LIBOR + 5.60%
	Eurobond	Aug. 17	DM250 (approx. \$170.0)	3 years	10% coupon
	Eurobond	Sept. 29	SwFr150 (approx. \$122.0)	3 years	7.50% coupon
United Mexican States	Euro FRN 144A ^a	Jul. 20	\$1,000.0	2 years	LIBOR + 5.375%
	Euro MTN	Aug. 17	¥100 billion (approx. \$1,100.0)	3 years	5% coupon
	Eurobond	Oct. 5 (to settle Nov. 2)	DM 1 billion (approx. \$700.0)	5 years	9.375% coupon
	Euro MTN	Nov. 30 (to settle Dec. 5)	\$1,500	1 year	Cetes - 6% or LIBOR
	Eurobond	Nov. 30 (to settle Dec. 12)	¥30 billion (\$293.6)	15 months	2.85% coupon
	Eurobond	Nov. 30	(to settle Dec. 12)	2 years	3% coupon

^aSection 144A bond issues are private placements and not subject to traditional disclosure requirements of other initial public offerings.

Legend

DM = Deutschemarks
 FRN = Floating rate note
 LIBOR = London Interbank Offered Rate
 MTN = Medium-term note
 SwFr = Swiss Francs
 ¥ = Yen

Source: U.S. Department of the Treasury.

The Mexican Bolsa Has Struggled After Initial Collapse

The peso devaluation and the subsequent loss of confidence by investors had an extremely adverse impact on the Bolsa, as discussed in chapter 2. After it reached a new low of 1,448 on February 27, 1995, the Bolsa demonstrated a significant recovery through August 1995. It had gained

36 percent in dollar terms by mid-June, on the strength of the international assistance package and an improved economic outlook for the Mexican economy as a whole. Further, the Bolsa climbed through July and August, as the Federal Reserve lowered U.S. interest rates. By September 8, after President Zedillo's State of the Nation address, the Bolsa index stood at 2,622. It has since fluctuated, sliding to 2,246 on October 27, 1995, then climbing back to 2,655 on December 8, 1995.

In an effort to provide a more efficient market, Mexico is taking steps to introduce new financial instruments that would modernize Mexican financial markets. First, the Bolsa and the Chicago Mercantile Exchange are developing distinct peso and interest futures contracts to create a North American standard for futures trading for pesos and Mexican Treasury interest rates.⁵ A Bank of Mexico official explained to us that the level of volatility in the peso exchange rate is expected to decline with the addition of the peso futures contract, so that international investors can hedge against exchange-rate risk. An official from the Bolsa told us that Mexico may gradually introduce other derivative⁶ financial instruments, such as warrants⁷ on individual Mexican securities and options⁸ on individual Mexican stocks.

Other Financial Indicators Also Show Progress

Other financial indicators show that Mexico has made progress in meeting its 1995 financial objectives. For example, the market for Mexican Brady⁹ bonds collateralized by U.S. Treasury bonds has improved. Interest rate spreads¹⁰ of these Mexican bonds over U.S. Treasury bonds declined from 1,937 basis points in mid-March to 902 basis points by August 24, a decrease of 10.37 percent. According to the November 30, 1995, Treasury

⁵Peso futures contracts have been trading on the Chicago Mercantile Exchange since April 1995.

⁶The market value of a derivatives contract is derived from a reference rate, index, or the value of an underlying asset. The underlying assets, rates, and indexes that determine the value of derivatives include stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of underlying financial products. See Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1995).

⁷Warrants are certificates giving the owner the right to buy financial instruments or commodities at a stated price for a stated period or at any time in the future.

⁸Options are contracts giving their owner the right to purchase or sell assets during a specified period at an agreed-upon price.

⁹Brady bonds, named after a former U.S. Treasury Secretary who promoted their use, are long-term dollar-denominated bonds converting international bank loans. Brady bonds are collateralized by 30-year, zero-coupon Treasury bonds for bond principal value and a reserve fund for interest payments.

¹⁰A spread is the difference between yields of securities of the same maturity but of different quality.

report, interest rate spreads closed November 1995 at 1,081 basis points. In addition, secondary market¹¹ tesobono interest rates dropped from 30 percent in late March to 8.5 percent by the end of August, a sign that investors were assigning less country risk for Mexican investments.

The Financial Crisis Has Added Stress to the Mexican Banking System

The government of Mexico's decision to devalue the peso in December 1994 placed additional stress on the Mexican banking system, which had already been facing problems following privatization. Mexican banks were privatized during 1991 through 1992, with the proceeds exceeding \$12 billion. However, Treasury reported that the buyers of the banks paid on average over three times book value for their acquisitions—a comparatively high price for the banks justified at the time by their reputed strong profitability and high margins but presumably requiring continued energetic performance. The buyers also inherited loan portfolio problems that had accrued during the period of government ownership, causing the percentage of overdue loans in Mexican banks to climb well before the December 1994 currency devaluation.

After the devaluation, Mexican banks came under pressure in several ways. First, many banks faced an immediate dollar liquidity problem in January, because pesos continued to be converted to dollars and foreign lenders were reluctant to roll over their dollar claims on Mexican banks in significant volume, according to Treasury. Second, the banks' capitalization levels were negatively affected by their dollar-based obligations as the peso continued to decline against the dollar. Third, banks' asset quality suffered as the percentage of nonperforming loans continued to rise, reaching an estimated 11.9 percent of total loans by the end of June in the face of dramatically rising Mexican interest rates.

Mexico Has Taken Steps to Help Solve Problems in the Banking Sector

The government of Mexico has taken a number of steps designed to help the banking sector deal with the problems associated with Mexico's financial difficulties. Several of these measures were initiated unilaterally by the government of Mexico; others, designed to assist the banking sector, were undertaken with the direct support of the international financial community.

Efforts to Improve Bank Liquidity

The Bank of Mexico, responding to the initial liquidity crisis among banks in January, created a currency credit program through Mexico's deposit

¹¹Secondary markets are exchanges and over-the-counter markets where securities are bought and sold after the original issuance. Proceeds of secondary market sales accrue to the selling dealers and investors, not to the entity that originally issued the securities.

insurance agency (FOBAPROA), to provide collateralized dollar loans for banks that needed dollars to meet maturing obligations. This FOBAPROA credit window was intended as a lender of last resort and therefore charged an interest rate designed to reflect the high dollar cost of these funds—25-percent interest. Nevertheless, Mexican banks used the credit window extensively in the early months of 1995, and total drawings reached a peak in mid-April of \$3.6 billion. The drawings then declined to about \$1.5 billion toward the end of June as market conditions improved and have generally been repaid since then.

Bank Capitalization Program

The government of Mexico has taken several measures to bolster the capitalization of the Mexican banking system. In February 1995, it launched the temporary capitalization program (PROCAPTE). PROCAPTE is a voluntary program designed to assist banks that have capitalization levels that fall below the internationally accepted standard of 8 percent of risk-weighted assets. Officials from Mexico's National Banking and Securities Commission explained that PROCAPTE is intended for use by viable banks that are facing short-term capital needs, rather than by problem banks that may require intervention. Banks in the PROCAPTE program issue subordinated debt,¹² purchased by the Bank of Mexico, in an amount sufficient to raise their capitalization level to 9 percent. The debt must be repaid within 5 years, or the Bank of Mexico will convert the debt to equity and sell the equity in the private market. In March 1995, six banks entered into the PROCAPTE program and issued approximately \$1 billion in subordinated debt. No additional banks had joined the program through the end of September, although Banca Serfin, Mexico's third-largest bank, was sufficiently recapitalized to be able to leave the program at the end of June.

The government of Mexico undertook another measure to increase the capitalization of Mexican banks by changing rules regarding foreign ownership of Mexican banks. The United States and Canada negotiated the opening of the Mexican banking system via NAFTA which, beginning in 1994, allowed foreign banks to own up to 8 percent of the net capital of the Mexican banking system. After the onset of the financial crisis, Mexico amended its banking law to permit the aggregate market share of foreign institutions to increase to 25 percent. As a result of these and other reforms, all but the three largest Mexican banks—Banamex, Bancomer, and Banca Serfin—can be acquired by foreign interests. In late spring, the Mexican bank Probursa and the Spanish bank Banco Bilbao-Vizcaya

¹²Subordinated debt is repayable in a bankruptcy only after more senior debt has been repaid.

reached an agreement that the latter would increase its ownership share in Probursa from 20 to 70 percent by a new capital infusion of \$350 million.

Efforts to Address Asset Quality Problems

The government of Mexico undertook a series of measures throughout 1995 to address the increase in nonperforming loans resulting from the peso's devaluation and the subsequent financial turmoil. Recognizing the need to deal with the deterioration of asset quality in the banking system at the onset of the financial crisis, Mexican bank regulators implemented a more stringent system for maintaining adequate loan loss reserves¹³ in early 1995. Banks were required to maintain either reserves for nonperforming loans of at least 60 percent, or reserves equal to 4 percent of the total loan portfolio, whichever is larger.¹⁴ Officials from Mexico's National Banking and Securities Commission told us that they are receiving technical assistance from several sources, including the World Bank, to help strengthen their supervisory capability. In addition, they said they have received a \$1.7-billion loan to recapitalize the deposit insurance fund of FOBAPROA, which will allow FOBAPROA to purchase assets and resolve failing institutions more effectively.

The government of Mexico also created a new program to help banks restructure portions of their loan portfolios to increase the likelihood that loans will continue to perform in the face of high inflation and interest rates. This program, the loan restructuring program (UDI), essentially allows loan repayments to be stretched out and weighted more heavily toward the end of the loan by denominating loans in a UDI instrument that is linked to the consumer price index. The borrowers repay a real rate of interest, while the real value of the principal is preserved and amortized over an extended maturity. According to Mexican officials, the program got off to a slow start since its implementation in April due to the need to train both bank personnel and borrowers on its operation and benefits.

Challenges to Mexico's Efforts to Recover Remain

Notwithstanding the efforts of the government of Mexico to improve bank liquidity, bolster the capitalization of the Mexican banking system, and institute the loan restructuring program for banks, the state of the Mexican banking system remains a concern. According to a U.S. Treasury report issued at the end of December 1995, Mexico's banking sector remains

¹³Reserves are financial assets that banks must keep in the form of cash and other liquid assets.

¹⁴The previous system gave Mexican banks discretion in classifying their loan portfolios in five categories. Under this system, banks created loan loss reserves based on requirements for each level of classification. In December 1994, provisioning, or reserves, for past due loans across all categories averaged 47.9 percent.

strained, with nonperforming loans still a drag on the banking system. According to the Treasury report, delinquent loans as reported by Mexico rose from a 1994 rate of 9 percent of all bank loans to about 17 percent of all bank loans by the end of September 1995. However, Mexican banks define nonperforming loans differently from U.S. banks. According to a World Bank official, the 17 percent reported by Mexico would equate to about 27 percent using U.S. generally accepted accounting principles to calculate nonperforming loans.

Despite the progress to date, Mexico still faces many difficult challenges before its financial crisis can be resolved. Interest rates continue to be high. For example, the real interest rate on 28-day cetes in mid-November was about 20 percent. In addition, the peso continues to be volatile, closing at a low of 8.14 pesos to the dollar on November 9 before strengthening to 7.55 pesos to the dollar on November 30. Economic growth for 1995, which was forecast at the start of the year by the Mexican government to show a decline of 2 percent for the year, has been much worse. After declining substantially in the first half of 1995, economic output in the third quarter contracted by 9.6 percent from the same period a year ago. Thus, it remains to be seen whether Mexico will be able to maintain economic policies that will allow the economy to recover from the crisis.

Use of the Exchange Stabilization Fund (ESF) and Federal Reserve Resources

U.S. monetary authorities may use two sources of funds to stabilize international currency markets: (1) ESF, which can provide loans, credits, guarantees, and reciprocal currency arrangements (swaps); and (2) the Federal Reserve swap network. Drawings on ESF and the Federal Reserve swap lines generally involve short-term exchanges of currencies through mutual purchases (i.e., swaps) with agreed-upon buying prices, reselling prices, maturities, and interest rates for the transactions. ESF swaps may be of longer duration. The purpose and use of these resources have evolved since their inception due to changes in the international monetary system. The Federal Reserve's foreign currency directive states that

"system operations in foreign currencies shall generally be directed at countering disorderly market conditions. . . . Transactions shall be conducted . . . in a manner consistent with the obligations of the United States in the International Monetary Fund. . . ."

The current statutory purpose of ESF is to promote a stable system of exchange rates, consistent with U.S. obligations in the International Monetary Fund (IMF). U.S. monetary authorities have a history of using these resources to assist Mexico, with the understanding that it is ultimately in the U.S. interest to promote an orderly exchange rate system.

History and Operations of ESF

ESF was established by section 20 of the Gold Reserve Act of January 30, 1934, (48 Stat. 337, 341) with a \$2-billion appropriation. Its resources were subsequently augmented by SDR allocations by IMF and through its net income over the years. Income for ESF since then has come from interest on short-term investments and loans, and net gains on foreign currencies. ESF engages in monetary transactions in which one asset is exchanged for another, such as foreign currencies for dollars, and could also be used to provide direct loans and guarantees to other countries. ESF operations are under the control of the Secretary of the Treasury, subject to the approval of the President.

ESF operations include providing resources for exchange market intervention. ESF has also been used to provide short-term swaps and guarantees to foreign countries needing financial assistance for short-term currency stabilization. The short-term nature of these transactions has been emphasized by amendments to the ESF statute requiring the President to notify Congress if a loan or credit is made to a country for over 6 months in any 12-month period.

Purpose of ESF	ESF provides flexibility to respond quickly to unexpected circumstances in international financial markets. Its purpose was changed in light of developments in the international monetary system during the 1970s. When the Bretton Woods system of fixed exchange rates was ended in 1973, IMF no longer required member countries to maintain fixed values for their currencies. To conform to this change in IMF, the purpose of ESF was altered from stabilizing the exchange rate of the dollar to other purposes consistent with U.S. obligations in IMF regarding an orderly and stable system of exchange rates.
ESF Resources	No funds have been appropriated to ESF since its creation in 1934 but, by law, special drawing rights (SDR) received by the United States from IMF have been allocated to ESF. ESF generates income from interest on short-term investments and loans. ESF invests the great bulk of its funds in highly liquid, high-quality U.S. and foreign government securities and receives interest and fees from loans to foreign countries. ESF has also had very substantial net gains from activity in foreign exchange markets. As of February 1995, total ESF resources available for lending were approximately \$25 billion equivalent. ESF dollar balances could be enlarged, if necessary, through monetizing or selling special drawing right certificates in the amount of SDR 1.5 billion and swapping some or all of its yen and deutschmark balances. As of the end of January 1995, yen balances were valued at \$11.9 billion, and deutschmark balances were valued at \$7.4 billion.
Background of Federal Reserve Swap Network	Operating as the U.S. central bank, the Federal Reserve participates directly in international financial markets by undertaking foreign exchange operations, most often direct operations in foreign exchange markets. An additional component of these operations is the reciprocal currency arrangement network, also known as the "Federal Reserve swap network." The Federal Reserve established its first swap arrangement with the Bank of France in 1962. It has subsequently made similar arrangements with 13 other central banks and the Bank for International Settlements (BIS).
Purpose of Federal Reserve Swaps	Like Treasury's ESF, the purpose of Federal Reserve foreign currency operations has evolved in response to changes in the international monetary system. After the transition from the Bretton Woods system of

fixed currency exchange rates to the present system of flexible currency exchange rates, the aim of the Federal Reserve's foreign currency operations has been to counter disorderly conditions in the exchange market through the purchase or sale of foreign currencies consistent with U.S. obligations in IMF.

**Federal Reserve
Swap Resources**

At the end of November 1995, the Federal Reserve had standing swap arrangements with the central banks of 14 nations and BIS. Resources available in the Federal Reserve swap network with these countries at that time equaled \$35.4 billion. \$3 billion of this \$35.4 billion is part of a \$6 billion swap arrangement with the Bank of Mexico that is available through January 31, 1996.

**Past U.S. Financial
Assistance for Mexico**

History of Assistance

The United States, through both ESF and Federal Reserve swaps, has a history of assistance to Mexico dating back to the late 1940s. Mexico is the only emerging market country that is part of the Federal Reserve swap network. Mexico's inclusion reflects both the close economic ties that the United States has with Mexico and the importance of Mexico's economy for the United States. Until implementation of the current assistance package, which made available long-term ESF swaps, both ESF and Federal Reserve transactions with Mexican authorities had been in the form of short-term currency swaps, i.e., with an ultimate maturity of 12 months or fewer.

ESF Assistance

Mexico's original standing swap line with Treasury was established in 1941. Mexico drew on this line in the late 1940s and in 1965. In 1965, a \$75-million reciprocal currency swap arrangement was established between ESF and Mexico. Between 1980 and 1994, Mexico drew on ESF six times, for amounts ranging from \$273 million to \$1 billion. Only one of these drawings was made on the standing swap line—all the rest were made under ad hoc swap arrangements. Except for a \$600-million drawing in 1982, which was repaid in 11 months, all drawings were repaid within 6 months.

Federal Reserve Assistance	<p>The first FRS swap line with Mexico, initially valued at \$130 million, was established in 1967. The size of this facility has grown over the years. The original swap line was raised in 1973 to \$180 million, in 1975 to \$360 million, and in 1979 to \$700 million. Then, in 1994, the amount was increased to \$3 billion. This standing \$3-billion swap line became part of the North American Framework Agreement—a trilateral swap facility between the United States, Canada, and Mexico—in April of 1994. The FRS swap line with Mexico is like the Federal Reserve swap arrangement with other central banks in that it is reviewed and renewed annually. In addition to the standing swap line with Mexico, there have been three ad hoc or “temporary” FRS swap lines made available to Mexico to address additional emergency needs since 1982. The most recent one was a \$1.5-billion temporary swap line, subsequently increased to \$3 billion on February 1, 1995. The temporary swap lines generally are not renewed.</p>
	<p>Mexico has drawn on FRS swap lines to meet its temporary end-of-month liquidity needs and to cover temporary shortfalls in its reserves, while it was awaiting other assistance from IMF and the World Bank. All FRS swap drawings by Mexico have been repaid in full by their maturity dates and, in some cases, before their maturity dates.</p>
U.S. Assistance for Mexico Always Had Similar Rationales	<p>According to U.S. government documents, Mexico drew on U.S. swap lines in 1974 to alleviate a shortage of dollar reserves. Drawings in the following 2 years were needed to counter financial market pressure on the peso, which eventually led to a 40-percent devaluation of the currency in August 1976. After Mexico sought assistance from IMF, the United States provided additional drawings as “bridge” facilities pending Mexico’s receipt of IMF funding. Rumors surrounding the economic policies of the Mexican President later that year led to continued pressure on the peso and subsequent drawings on ESF and FRS swaps. All of these drawings were repaid on time.</p>
	<p>The heaviest drawing activity by Mexico on United States swap lines was in the early 1980s, surrounding the debt crisis of that period. An untenable external debt burden led to new pressure on the peso and another 40-percent devaluation in 1982. During the 1980s, Mexico had five drawings on U.S. swap lines, three of which were part of multilateral facilities with other countries.</p>

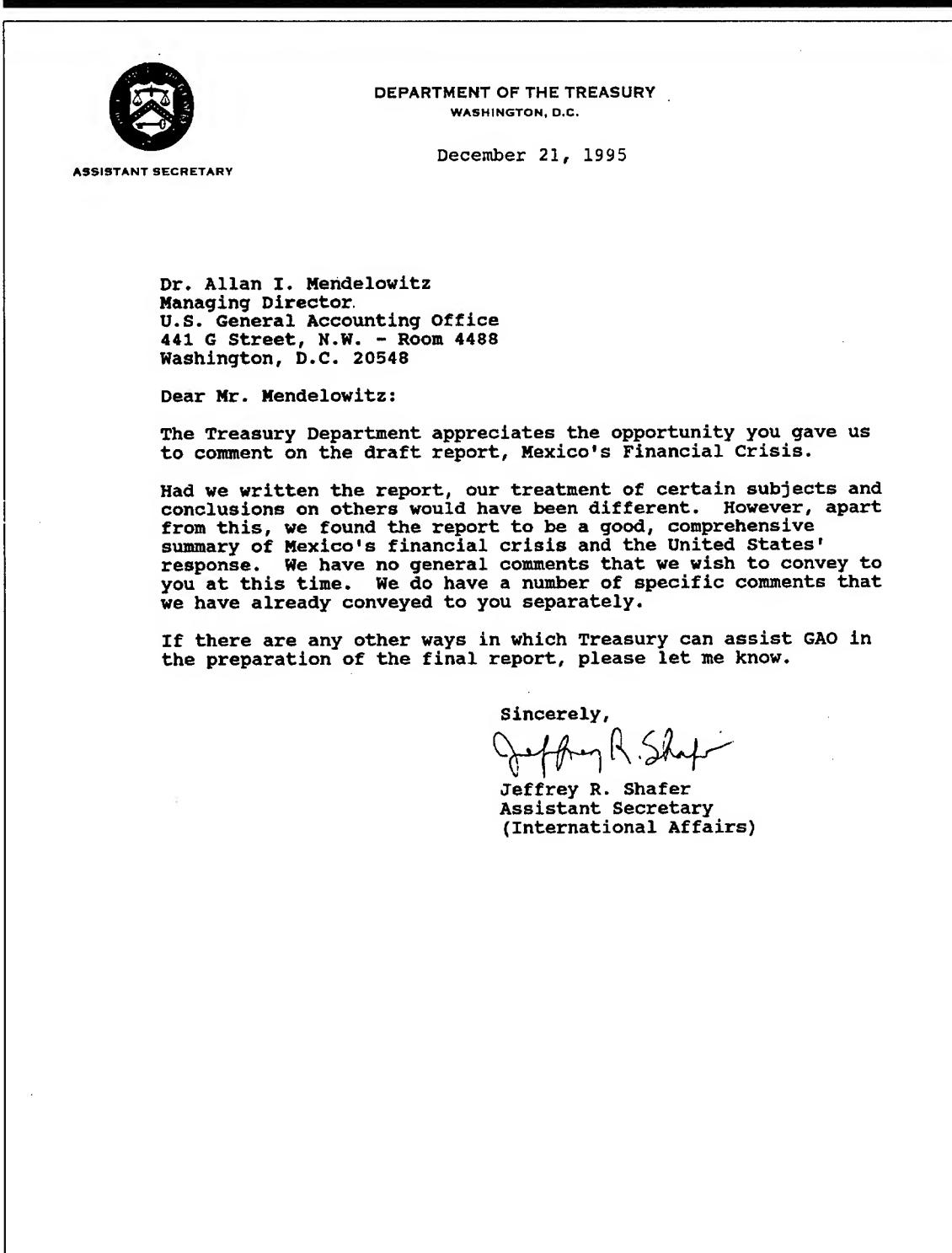
Currency Swap Operations

In a swap transaction, two countries simultaneously agree to exchange an amount of each other's currencies and to reverse that transaction at a later date at a specified exchange rate. The initiating country takes the currency it obtains, e.g., dollars, and uses it to finance transactions to support its own currency. The country later acquires dollars on the open market, which are used to "reverse the swap" by paying back dollars to the United States. In a U.S. dollar swap transaction, an initiating country agrees to pay interest on the U.S.'s foreign currency holdings based on the 91-day Treasury bill rate. Likewise, the United States pays a comparable rate on the foreign country's dollar counterpart when it makes a drawing if these dollars are invested in Treasury securities. Given the ESF's current investment practices, there is no exchange rate risk to either party in a currency swap, since the exchange rate at which the currency is bought and sold is predetermined in the agreement. There is no opportunity cost¹ or loss of income associated with swap transactions.

In considering a request to initiate a swap, the United States seeks assurance that the drawing country has a reasonable prospect of prompt fulfillment of the swap arrangement terms. Such assurance could include considering the foreign currency reserve levels of the initiating country, or taking into account the prospective proceeds or borrowings from international financial institutions such as IMF or the World Bank.

¹Opportunity cost is the cost of pursuing one course of action in terms of the foregone return offered by the most attractive alternative with the same risk.

Comments From the Treasury Department



Comments From the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

December 4, 1995

Mr. Allan I. Mendelowitz
Managing Director
International Trade, Finance,
and Competitiveness
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Mendelowitz:

Thank you for providing the Board of Governors of the Federal Reserve System with the opportunity to review and comment on the General Accounting Office's draft report entitled Mexico's Financial Crisis -- Origins, Awareness, Assistance, and Efforts to Recover. The draft report presents on the whole a balanced and comprehensive appraisal of the origins and response to the Mexican financial crisis of 1994-95. We have no substantive disagreement on the thrust of the draft report's principal findings, recognizing that assessing the complex set of events associated with the Mexican crisis involves matters of judgment in which there is room for differences of view or emphasis.

The Board's staff have read the draft report with care, and they will be providing technical comments under separate cover.

Very truly yours,

A handwritten signature in black ink, appearing to read "William W. Wiles".

William W. Wiles
Secretary of the Board

Major Contributors to This Report

General Government Division, Washington, D.C.

Allan I. Mendelowitz, Director
Susan S. Westin, Assistant Director
Curtis F. Turnbow, Assistant Director
Patrick S. Dynes, Evaluator-in-Charge
Wayne H. Ferris, Senior Evaluator
David T. Genser, Senior Evaluator
Philip J. Mistretta, Senior Evaluator
Kurt A. Burgeson, Evaluator
Michael A. Tovares, Evaluator
Rona Mendelsohn, Senior Evaluator (Communications Analyst)

Los Angeles Regional Office

Patrick F. Gormley, Assistant Director
Juan R. Gobel, Senior Evaluator
Anthony P. Moran, Senior Evaluator

Office of the General Counsel, Washington, D.C.

Sheila K. Ratzenberger, Assistant General Counsel
Rosemary Healy, Senior Attorney

Glossary

Basis Points	The smallest unit in quoting yields on bonds, mortgages, and notes, equal to one one-hundredth of one percentage point.
Brady Bonds	In the case of Mexico, bonds issued in seven different currencies as part of a 1989-92 financing package for Mexico. Mexico's Brady bonds consist of collateralized bonds with a U.S. dollar equivalent value of approximately \$30 billion maturing in December 2019. The bonds are named after the former Secretary of the Treasury—Nicholas Brady. Brady bonds are also issued by a number of other countries.
Bridge Loans	Short-term credit extended in anticipation of longer-term financing, most often arranged in conjunction with IMF and World Bank programs.
Cetes	Short-term, peso-denominated Mexican treasury certificates.
Country Risk	Country risk is the risk that economic or political changes in a foreign country—for example, lack of foreign exchange reserves—will cause delays in payments to creditors, the imposition of exchange controls, or even the repudiation of debt. Country risk is broader in scope than sovereign risk in that it takes into account the probability of debt repayment by private borrowers as well as central governments.
Credit Risk	Risk that a borrower will not pay an obligation as called for in an agreement and that the borrower may eventually default on the obligation.
Currency Swap	An agreement to simultaneously exchange, buy for spot and sell for future delivery, one currency for another at agreed-upon exchange and interest rates, with the currencies being returned to their original owners at a specified future date.
Current Account	This is the broadest measure of a country's international trade in goods and services. Its primary component is the balance of trade, which is the difference between merchandise exports and imports.

Exchange Rate Policy	A government's policies concerning the price at which its currency can be converted into another.
Exchange Stabilization Fund	Currency reserve fund of the U.S. government employed to stabilize the dollar and foreign exchange markets. ESF is managed by the Treasury. The Federal Reserve Bank of New York acts as fiscal agent for Treasury. ESF holds special drawing rights allocated to the United States by IMF.
Exchange Rate Risk	The possibility that the value of a foreign currency will be diminished due to unforeseen changes in foreign currency exchange rates.
Eurobonds	Corporate or government bonds issued outside the country of the issuer and denominated in a currency other than the currency of the country in which the bonds are issued. Eurobonds are issued in bearer form—payable to the holder. Various regulations may apply. For example, if a bond is to be listed on an exchange, it must meet the requirements of the exchange. The U.S. Securities and Exchange Commission has regulations that must be complied with if an offshore offering is to be exempt from registration. Borrowing in the Eurobond market often makes it possible to obtain financing at lower interest rates.
Foreign Currency Risk	See Exchange Rate Risk.
Foreign Direct Investment	Foreign direct investment occurs when citizens of one nation purchase assets in some other nation that give them managerial control of economic activities related to those assets.
Foreign Portfolio Investment	The purchase by one country's private citizens or their agents of marketable noncontrolling positions in foreign equity and debt securities issued by another country's private citizens, corporations, banks, and governments.
Foreign Exchange	Foreign exchange is currency used in the settlement of international finance and trade between countries.

Foreign Exchange Market	The foreign exchange market is an interbank or over-the-counter market in foreign exchange that is a network of commercial banks, central banks, brokers, and customers.
Foreign Exchange Reserves	The stock of official assets denominated in foreign currencies held by the monetary authorities (finance ministry or central bank). Reserves enable the monetary authorities to intervene in foreign exchange markets to affect the exchange value of their domestic currency in the market. Reserves are typically part of the balance sheet of the central bank and are managed by the central bank. Reserves are generally invested in low-risk and liquid assets—often in foreign government securities.
Foreign Exchange Risk	See Exchange Rate Risk.
Forward Market	A market where dealers agree to deliver currency, financial instruments, or commodities at a fixed price at a specified future date.
Futures Market	A market where futures contracts are traded. Futures contracts are negotiable contracts to make or take delivery at an agreed-upon price of a standardized amount of a commodity or financial instrument during a specified month.
Group of Ten	A group of 11 major industrial countries, members of IMF, that participate in IMF's General Arrangements to Borrow and that consult on general economic and financial matters in various forums. The 11 are Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.
London Interbank Offer Rates	Key interest rates at which the major banks in the London interbank market are willing to borrow funds from each other at various maturities and for different currencies. It has become the most important floating rate pricing benchmark for loans and debt instruments in the global financial markets. These rates are published daily by the Bank of England and are based on a sampling from a group of reference banks that are active in the Eurocurrency market, but agreements that use LIBOR do not necessarily rely on quotes published by the Bank of England.

Market Risk	The risk that a financial instrument will vary in price as market conditions change.
Macroeconomic Policy	Macroeconomic policy concerns a nation's economy as a whole including, among other things, price levels, unemployment, inflation, and industrial production.
Opportunity Cost	The cost of pursuing one course of action in terms of the foregone return offered by the most attractive alternative of equivalent risk.
Portfolio Investment	Investment in marketable debt and equity securities. Unlike direct investment, it does not seek managerial control.
Set-Off Clause	Set-off clauses give a bank a right to seize deposits at that bank that are owned by a depositor or debtor for nonpayment of an obligation to that bank.
Sovereign Debt	The debt instruments of the central government of a country. Debt instruments are typically bonds evidencing amounts owed and payable on specified dates or on demand. Sovereign debt is not secured by specific collateral but by penalties that creditors may impose on the government—such as reduced access to financial credits, world capital markets, or attachment of government assets.
Sovereign Risk	Sovereign risk is the risk of default by a foreign central government or an agency backed by the full faith and credit of the government.
Standby Credit	A letter of credit that represents an obligation by the issuing organization to the beneficiary and that is contingent on the ability of the beneficiary to perform under the terms of a contract.
Subordinated Debt	Debt that is repayable only after other debt with a higher claim has been satisfied.

Swap	See Currency Swap.
Systemic Risk	Systemic risk is the possibility that failure of one or more financial organizations or countries will trigger a chain reaction and cause the collapse of other financial organizations or countries. Systemic risk is the risk that a disturbance could severely impair the workings of the financial system and, at the extreme, cause a complete breakdown. A breakdown in capital markets could disrupt the process of savings and investment, undermine the long-term confidence of private investors, and cause turmoil in the normal course of economic transactions.
Tesobonos (Bonos de La Tesoreria de La Federacion)	Discounted, or zero-coupon, dollar-indexed, short-term obligations of the Mexican government that are payable in pesos and, since late March 1995, in dollars. They were auctioned on a weekly basis and issued with maturities in multiples of 7 days—typically 28, 91, 182, and 364 days. They have a face value of \$1,000 U.S. dollars and are book entry securities—that is, they are not available to investors as certificates. They were issued at a discount, but the government of Mexico could choose to make periodic interest payments. Banks can contract with their customers to provide settlement in dollars at the times they are repaid, but the authorities are under no obligation to supply needed dollars to the banks. They are repaid on the date of maturity to banks acting as brokers for their customers based on average prices quoted by various foreign exchange dealers.
Transfer Risk	The possibility that a foreign government may tax or restrict the repatriation of earnings, capital, or foreign exchange. It is the possibility that the value of an investment denominated in a foreign currency will be diminished due to government-imposed regulations restricting the ability to repatriate all or some earnings.

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